



governmentattic.org

"Rummaging in the government's attic"

Description of document: A copy of each response to a Question for the Record (QFR) provided to Congress by the Commodity Futures Trading Commission (CFTC), 2009-2014

Requested date: 13-June-2014

Released date: 04-December-2015
2nd release date: 04-March-2016

Posted date: 21-March-2016
Update posted date: 03-January-2017

Note: Material released 04-December-2015 begins PDF page 2; material released 04-March-2016 begins PDF page 933

Source of document: Freedom of Information Act Request
FOIA Compliance Office
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581
Email: FOIASubmissions@cftc.gov

The governmentattic.org web site ("the site") is noncommercial and free to the public. The site and materials made available on the site, such as this file, are for reference only. The governmentattic.org web site and its principals have made every effort to make this information as complete and as accurate as possible, however, there may be mistakes and omissions, both typographical and in content. The governmentattic.org web site and its principals shall have neither liability nor responsibility to any person or entity with respect to any loss or damage caused, or alleged to have been caused, directly or indirectly, by the information provided on the governmentattic.org web site or in this file. The public records published on the site were obtained from government agencies using proper legal channels. Each document is identified as to the source. Any concerns about the contents of the site should be directed to the agency originating the document in question. GovernmentAttic.org is not responsible for the contents of documents published on the website.



FOIA Office

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5105
Facsimile: (202) 418-5124
www.cftc.gov

December 4, 2015

RE: 15-00200-FOIA
Request for a copy of Question for the
Record (QFR)

This is in response to your request dated June 13, 2014, under the Freedom of Information Act seeking access to seeking a copy of each response to a Question for the Record (QFR) provided to Congress by the CFTC from January 1, 2009 to June 13, 2014. In accordance with the FOIA and agency policy, we have searched our records, as of August 7, 2015, the date we received your request in our FOIA office.

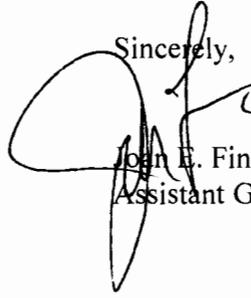
We have located and reviewed 629 pages of responsive record thus far, and we are continuing our search for additional records. This is a voluminous collection of records and we will continue to send you responsive records on a rolling basis. I am granting partial access to, and am enclosing copies of, the accessible records. Portions of these pages fall within the exemptions to the FOIA's disclosure requirements, as explained below.

Some records contain personal information, which is exempt from release under FOIA Exemption 6 because individuals' right to privacy outweighs the general public's interest in seeing personal identifying information. 5 U.S.C. § 552(b)(6); *See also The Lakin Law Firm v. FTC*, 352 F.3d 1122 (7th Cir. 2003).

If you are not satisfied with this response to your request, you may appeal by writing to Freedom of Information Act Appeal, Office of the General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 8th Floor, 1155 21st Street, N.W., Washington, D.C. 20581, within 30 days of the date of this letter. Please enclose a copy of your original request and a copy of this response.

If you have any questions about the way we handled your request, or about our FOIA regulations or procedures, please contact Linda J. Mauldin at 202-418-5497.

Sincerely,

A handwritten signature in black ink, appearing to read 'Joan E. Fina'. The signature is stylized with a large, rounded initial 'J' and a vertical line for the 'F'. There is a small flourish at the end of the signature.

Joan E. Fina
Assistant General Counsel

**NOMINATION HEARING TO CONSIDER
GARY GENSLER TO BE CHAIRMAN OF THE CFTC**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
FEBRUARY 25, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

54-564 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

| | |
|------------------------------------|---------------------------|
| PATRICK J. LEAHY, Vermont | SAXBY CHAMBLISS, Georgia |
| KENT CONRAD, North Dakota | RICHARD G. LUGAR, Indiana |
| MAX BAUCUS, Montana | THAD COCHRAN, Mississippi |
| BLANCHE L. LINCOLN, Arkansas | MITCH McCONNELL, Kentucky |
| DEBBIE A. STABENOW, Michigan | PAT ROBERTS, Kansas |
| E. BENJAMIN NELSON, Nebraska | MIKE JOHANNIS, Nebraska |
| SHERROD BROWN, Ohio | CHARLES E. GRASSLEY, Iowa |
| ROBERT P. CASEY, Jr., Pennsylvania | JOHN THUNE, South Dakota |
| AMY KLOBUCHAR, Minnesota | |
| KIRSTEN GILLIBRAND, New York | |
| MICHAEL BENNET, Colorado | |

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|---|------|
| HEARING(S): | |
| Nomination Hearing to Consider Gary Gensler to be Chairman of the CFTC .. | 1 |

Wednesday, February 25, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|---|---|
| Harkin, Hon. Tom, U.S. Senator from the State of Iowa | 1 |
| Cardin, Hon. Benjamin L., U.S. Senator from the State of Maryland | 6 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 2 |
| Lugar, Hon. Richard G., U.S. Senator from the State of Indiana | 3 |
| Mikulski, Hon. Barbara A., U.S. Senator from the State of Maryland | 4 |
| Sarbanes, Hon. Paul, former U.S. Senator from the State of Maryland | 7 |

Panel I

| | |
|--|---|
| Gensler, Gary, Nominee to be Chairman and Commissioner of the Commodity Futures Trading Commission | 9 |
|--|---|

APPENDIX

| | |
|---|-----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 40 |
| Gensler, Gary | 43 |
| DOCUMENTS SUBMITTED FOR THE RECORD: | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Gary Gensler | 46 |
| Various organizations, letters of endorsement for Gary Gensler | 70 |
| QUESTION AND ANSWER: | |
| Harkin, Hon. Tom: | |
| Written questions for Gary Gensler | 74 |
| Brown, Hon. Sherrod: | |
| Written questions for Gary Gensler | 77 |
| Casey, Hon. Bob: | |
| Written questions for Gary Gensler | 78 |
| Grassley, Hon. Charles E.: | |
| Written questions for Gary Gensler | 79 |
| Nelson, Hon. Ben: | |
| Written questions for Gary Gensler | 81 |
| Roberts, Hon. Pat: | |
| Written questions for Gary Gensler | 82 |
| Stabenow, Hon. Debbie: | |
| Written questions for Gary Gensler | 84 |
| Gensler, Gary: | |
| Written response to questions from Hon. Maria Cantwell | 85 |
| Written response to questions from Hon. Dianne Feinstein | 98 |
| Written response to questions from Hon. Carl Levin | 108 |

**NOMINATION HEARING TO CONSIDER
GARY GENSLER TO BE CHAIRMAN OF THE
CFTC**

Wednesday, February 25, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 2:40 p.m., in room SD-106, Dirksen Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Conrad, Stabenow, Nelson, Klobuchar, Chambliss, Lugar, Roberts, Grassley, and Thune.

**STATEMENT OF HON. TOM HARKIN, U.S. SENATOR FROM THE
STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**

Chairman HARKIN. The Senate Committee on Agriculture, Nutrition, and Forestry will come to order. I know we just had a vote. We are waiting on some Senators to arrive. Senator Chambliss said he would be a few minutes late and to go ahead and proceed.

Good afternoon, and we thank you all for joining us today. We meet this afternoon to consider the nomination of Mr. Gary Gensler to serve as the Chairman of the Commodity Futures Trading Commission. As many of you know, Mr. Gensler is not new to public service. He served as Assistant Secretary for Financial Markets, and later as Under Secretary for Domestic Finance at the Department of Treasury. He was at Treasury about 3 years, so he brings this experience to this CFTC position.

This nomination comes at a very challenging time. Since the CFTC was created 35 years ago, it has never faced more daunting market challenges than those that the next Chairman and Commissioners will face. Our financial markets are still unstable, and the physical commodities of energy, agriculture and metals have experienced dramatic price movements and volatility.

Again and again, actions in our futures markets have caused some havoc across our country and economy. I thought about this, and in principle are supposed to provide some stability and certainty and not to create havoc.

One year ago this weekend, we had an experience in the cotton market. Speculative funds ran up the prices of the cotton futures market at a time when there were record surpluses of cotton and not very much demand. So there was a ton of money, speculative money, going into the futures markets that had absolutely nothing

to do with supply and demand. It served no constructive economic purpose except maybe to make some people wealthy.

The markets for other agricultural commodities experienced similar disruptions for wheat, corn, and soybeans. They rose to record levels last year. Country elevators that had offered producers forward contracts and then hedged their positions on the Chicago Board of Trade struggled to find the cash resources to meet margin calls. Users of commodities from bakers to pork producers to ethanol facilities, suddenly realized that the price they would have to pay for the most critical inputs was double the price they had paid just a couple months before.

Prices in the energy sector also shot up to unprecedented levels last summer. Energy users from airlines to commuters to farmers struggled with higher fuel costs. So in places like my State of Iowa, people are wondering; is Washington really asleep at the switch? Do we understand the disruption and damage caused by ineffective and inadequate oversight and regulation?

Last night, President Obama urged Congress to move quickly on legislation that will finally reform our outdated regulatory system. He called for tough new common-sense rules of the road so that our financial market rewards drive innovation and punishes short-cuts and abuse. So it is our responsibility to rise to the President's challenge.

This Committee and the Commodity Futures Trading Commission have a profound responsibility to craft and implement tough-minded regulatory reforms. Last month, I reintroduced the Derivatives Trading Integrity Act. "Integrity" is a synonym for honesty. The bill would require that all futures contracts trade on a regulated exchange, including all derivatives contracts. I came to that position after our hearing in October on derivatives. Exchange-traded contracts are subject to a level of transparency and oversight that is just not possible in over-the-counter markets.

The best-intentioned and most brilliantly crafted legislation will be only as effective as the regulators who implement it. We must have an unflinching determination on the part of the Commodity Futures Trading Commission to restore integrity to these important markets.

That is why the position of Chairman of the CFTC is so critical. And that is why this Committee must gain assurance that the nominee before us is prepared to provide strong leadership at the CFTC, to work with this Committee to develop solutions to ensure that markets are open, transparent, free of excessive speculation, and that all trades clear. We need to know if Mr. Gensler will be committed to repairing the damage from abuses and mistakes of the past and ensuring that they are never repeated.

With that, I will hold the record open at this point for a statement by Senator Chambliss. I would ask if Senator Lugar or others would have opening statements that they would care to make at this time.

Senator Chambliss, for an opening statement.

**STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM
THE STATE OF GEORGIA**

Senator CHAMBLISS. Mr. Chairman, thank you.

I will submit my opening statement for the record, and let me just echo, Mr. Gensler, we welcome you to the Committee, and we welcome your girls to the Committee.

We have had the opportunity to visit and obviously I know your background. We look forward to continuing a dialog on the issues that we know face this industry and look forward to working with you down the road with respect to making sure that we continue to provide financial investors in this country the type of regulation that is fair, reasonable, and will ensure safety and security in the market.

So thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss.

Senator Lugar.

**STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR
FROM THE STATE OF INDIANA**

Senator LUGAR. Mr. Chairman, let me just add that I appreciated especially the hearing you conducted in which we participated last October. I felt that was an educational experience for us and for the American people, and I appreciate the progress that has occurred at CFTC subsequent to that hearing. People were able to do some things administratively.

But I would just simply chime in to say that as a very junior Senator, Senator Leahy and I sat at the end of the table and were assigned by Chairman Herman Talmadge the responsibility of oversight of the CFTC, because apparently no one else on the Committee understood what he was doing and no one really wanted to find out. So we have had some parental responsibilities in subsequent years, and I appreciate very much the evolution. But this is a pivotal moment today as we take a look at a new chairmanship, a new era, the regulatory suggestions you have made and other members likewise. And so I look forward to the hearing.

Chairman HARKIN. Thank you very much, Senator Lugar.

Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman. Unfortunately, I have to leave, so I am going to make a couple of statements and leave open a question which I hope Mr. Gensler can respond back to us in writing.

You have outlined very clearly and succinctly the problems that we face today with the volatility that we have experienced in the markets. I hope we have the opportunity to see where the weaknesses are and what fixes are necessary. Credit derivatives, obviously regular commodities, physical commodities, need to be bound by certain rules. But it is important that whatever regulations are put in place does not constitute strangulation of the commodities in the whole.

I think the CFTC must preserve the price discovery aspect of the markets and risk management hedging benefits that it provides. It needs to regulate with a focus on what has become more and more important, the system risk, and not just look for bad actors in the situation.

I think the thing that interests me most is the need that the CFTC should be proactive and try to anticipate matters that pose a threat to systemic risk than always be reacting. I know it is a

very challenging thing to be able to predict and to anticipate without some market experience to guide you as to what needs to be done. But waiting until the systemic risk is so big or the fire is beyond the capability of being put out is not a course of action that we would like to see happen again.

The question that I really have of Mr. Gensler, should he be confirmed, is—we proposed that the CFTC issued—they issued a report, and we came back and we asked that the report's recommendation of the review of, quote, whether to eliminate the bonafide hedge exemption for swap dealers and replace it with a new risk management exemption subject to certain conditions that we suggested that be done. And my question is do you know whether that has been done or, if it has not, whether it will be done. And if you can just get back to me on that, that certainly will satisfy me.

But thank you very much for your willingness to serve, and I look forward to my two colleagues giving a great introduction of you. Thank you.

Chairman HARKIN. Thank you, Senator Nelson.

Senator Grassley.

Senator GRASSLEY. Yes, thank you very much, Mr. Chairman. Obviously, we need to congratulate Mr. Gensler. I think we ought to also thank Walt and Michael for their acting chairmanship and the hard work that they put into the work of the Commission. I think our last year has shown that more aggressive activity on the part of the CFTC is really needed.

This is a year when we are going to have to decide to a greater extent the appropriate role of regulation of speculators to a greater extent than we have in the past. We are going to have to decide if we are serious about giving the CFTC the resources it needs to do its job effectively. And that is what new leadership is all about, I hope, and, of course, the work of this Committee as well.

So I am not going to be able to stay around here to ask questions, but I told Mr. Gensler that I would be submitting about eight questions for answer in writing. So I thank you, Mr. Chairman, for the privilege of making a statement, and I will put my entire statement in the record.

Chairman HARKIN. Thank you very much, Senator Grassley.

We have a distinguished colleague and a distinguished former colleague, and I will recognize them in order for purposes of introduction. Senator Mikulski from the great State of Maryland, welcome to the Agriculture Committee.

**STATEMENT OF HON. BARBARA A. MIKULSKI, U.S. SENATOR
FROM THE STATE OF MARYLAND**

Senator MIKULSKI. Thank you very much, Mr. Chairman, and also Senator Cardin, who is currently presiding, will also be joining us, and it shows the enthusiastic support that Mr. Gensler enjoys from the Maryland delegation.

First of all, in terms of the Commodity Futures Trading Commission, we know how important this Commission is. But as Senator Lugar so aptly said, it is often little understood or little noted, unless there is a crisis in the markets. And last summer, also the

whole issue of commodities and the futures trading just exploded in our community and our media and in our marketplace.

I had bakers lined up throughout in my office and out in the community wondering how they were going to buy rye and wheat and so on to keep their small and medium-sized businesses going. We were talking about the high price of gasoline. We were talking about something called the "London loophole" and how we needed to close that.

So the whole issue of commodities we are seeing not only as something that was primarily an Agriculture Committee issue, but an American issue and how it affects our community.

There is grave concern whether there was adequate oversight, adequate regulation, and what we needed to do. Well, I think now we are on the path in the right direction. But whatever the rules of the road, whatever Congress chooses to do, we need to have the right person in charge of the CFTC. That is why I enthusiastically endorse and introduce Gary Gensler to the Committee to be the Chairman of the Commodity Futures Trading Commission. We know his work when he was in the Senate. We know his work in the Clinton administration, and also he is and continues to be a community leader in Maryland.

I know him to be a man of principle and great intelligence. He has a deep understanding of finance, both domestic and international, and how to turn that knowledge into workable policies that will protect the interests of our country and the interests of our consumer.

During this time of great financial turmoil and uncertainty, we need someone with these skills, this background and experience, and these values to lead the Commission. So I enthusiastically support him for this important position.

When you look at his resume, we know that he worked hard at Treasury and received the Alexander Hamilton Award, the highest award that the Department can give. He worked with our colleague Senator Sarbanes in terms of fashioning a response to not only the Enron scandal, but how we could make corporate America more responsible, the Sarbanes-Oxley bill.

He has worked as a top economic adviser both in our own government and on Wall Street. He is also a strong community leader. Whether he has been on the board of Johns Hopkins University or whether he has helped the Community Enterprise Foundation be able to provide affordable housing, Gary has always been someone who has given of his own time and, I might add, of his own dime.

And just speaking as a woman, I watched him and my heart went out to him when his own beloved wife, Francesca, struggled with breast cancer. He had to be a father; he had to be a mother; he had to be a devoted husband. He was always at his wife's side, and at the same time tending to his children.

Someone who knows what sorrow is and has to go through that, and also what it means to his family, and then while he was doing that, to stay civically engaged while at the same time watching the marketplace. I think we have someone who brings talent, who brings dedication, and who brings values. I think the Committee would be well served in approving his nomination.

Chairman HARKIN. Thank you very much, Senator Mikulski, for that very strong supportive statement.

Now our distinguished former colleague, Senator Sarbanes. Welcome back.

Senator SARBANES. Mr. Chairman, thank you very much, and I appreciate your courtesy in allowing me to appear. It is a risky proposition on your part because former Senators do not get much of a chance to speak, and there is always a danger they will abuse the microphone when the opportunity presents itself. But I know you want to move along.

Actually, I will withhold and defer to Ben and keep it in—I am out of office, and they are in office, and I respect the difference very much. Do you want to go ahead?

Senator CARDIN. I usually yield to my constituents, and Senator Sarbanes is my constituent. But let me—

[Laughter.]

Chairman HARKIN. Senator Cardin.

**STATEMENT OF HON. BENJAMIN L. CARDIN, U.S. SENATOR
FROM THE STATE OF MARYLAND**

Senator CARDIN. Mr. Chairman, let me thank you for the courtesy of just a few remarks with regard to Gary Gensler. He is a friend. He is a person I have known for many years. I deeply respect his intellect, his integrity, his financial knowledge, and his commitment to public service. And I join Senator Mikulski and Senator Sarbanes in recommending him for confirmation.

Gary has a tremendous depth and breadth of knowledge on financial issues. He was in the Department of Treasury from 1997 to 2001, Assistant Secretary for Financial Markets and Under Secretary for Domestic Finance. He was a senior adviser to both Secretary Rubin and Secretary Summers.

He received the Treasury Department's highest award, the Alexander Hamilton Award. He was an adviser to a very distinguished member of the U.S. Senate, Chairman Sarbanes, when Paul chaired the Banking Committee and helped Senator Sarbanes when we passed the Sarbanes-Oxley legislation, which regulated corporate America—very important legislation on corporate responsibility—we could use more of that today—and accounting and security laws.

So Gary is well prepared through his experience to take on this very important responsibility as Chair of the Commodity Futures Trading Commission. But I want to tell you just one more thing about him. His background in the community, the type of volunteer activities that he has committed himself to, in helping educational institutions and helping health care institutions and helping those who are disadvantaged. It tells you a lot more about him. He is a person committed to our community.

I will tell you one more thing about him. He has participated in nine marathons, and if he is confirmed, helping repair our economy will be his tenth marathon, and I am sure he will be just as determined to bring us to a successful goal, and I encourage his confirmation.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Cardin.

Now Senator Sarbanes.

**STATEMENT OF HON. PAUL SARBANES, FORMER U.S.
SENATOR FROM THE STATE OF MARYLAND**

Senator SARBANES. Well, thank you very much, Mr. Chairman.

First of all, I want to just underscore something that both Senator Mikulski and Senator Cardin said, and that is the very substantial, positive contribution that Gary Gensler has made in the Baltimore community through his civic involvement. If we talk about being a good citizen and sort of participating and meeting your responsibilities, this is a prime example of someone who has done that. And it has been of enormous benefit to our community, and we are all deeply indebted to him for it.

He has been in a sense a star from the beginning. He was a summa cum laude graduate from the Wharton School of Business at the University of Pennsylvania, first a BA and then an MBA. He then went to work in the financial industry where he had extensive experience, and then he was in the Treasury for, I think, close to 4 years. He then wrote a book about mutual funds, and then I was fortunate enough—I was then Chairman of the Banking Committee, and we were confronted with the Enron situation.

Enron was the seventh largest company in the country. It was reporting record profits in the first part of 2001, first quarter, second quarter, 20-percent increase in profits each quarter. By October, they were restating their earnings. November, they restated them again. December, they declared bankruptcy. The largest bankruptcy in U.S. history up to that point. It was subsequently eclipsed by WorldCom in June of 2002.

The Committee, which I then chaired, was charged with the responsibility of addressing the situation, and one of the things we did which made an enormous difference, as it turned out, was to get Gary Gensler to come and work with us as a senior adviser to the Chairman. And his contribution was enormous.

He was integrally involved in shaping the legislation, which, of course, dealt with oversight of the accounting industry, the reform of corporate governance, and investor protection measures. And let me just quickly outline for the Committee the qualities he brought to that work, which I think will stand all of us in good stead should he be confirmed as Chairman of the CFTC.

First of all, he thinks comprehensively in terms of what is necessary to make the financial system work. So he has a breadth and depth of vision which is somewhat rare, but which is extremely important, particularly when you are trying to deal with a situation where the system is breaking—seems to be breaking down and it needs to be, as it were, restructured and put back together again.

He is extremely smart. I indicated his past accomplishments. Nowadays, people are around developing more and more complex instruments all the time, and you have got to have someone there who can not only stay with them every step of the way, but can be ahead of them, can anticipate what is coming and seek to address it.

He knows the markets well, and he is very committed to ensuring that the markets work honestly and fairly. And the markets are an important part of the workings of our economic system. But

if they do not work honestly and fairly, they will drive the economic system down, and all of us will pay a very high price for that.

He is very hard-working. He is not ideological. He is pragmatic. He is a good listener. He seeks practical solutions, seeks to develop constructive and positive approaches. He is firm and fair. And he brings excellent judgment and very strong leadership skills. I think he will be very effective in heading the agency and imparting a sense of mission to the employees in terms of what needs to be done.

I want to say to the members of the Committee, I have absolute confidence in his integrity and in his judgment, and I think it is an opportunity for the country to put his superior understanding of financial markets and his extensive experience to work on behalf of the American people. I can assure you he will be a fierce enemy of fraud and manipulation, that he will find it, root it out, and also try to make the systemic changes that will contribute to it not recurring again, which is, of course, very important. We can go after the bad actors, but we want to have a system in place that precludes the bad actors from coming along in the first place.

Gary Gensler has a very, very deep commitment to the public interest. I have had occasion to talk to him at length about his feeling for the country, his own opportunities in life, and the need to make the system work fairly for all.

And, finally, Mr. Chairman, let me just say he appreciates, I think, the role of the Congress and the workings of our political system. Sometimes you get these people in the executive branch, and they have difficulty understanding there is a legislative branch that plays a very important role. Gary Gensler I think clearly understands the role of the Congress. I think he is sensitive to it. He appreciates it is an important partner. And I want to say to the Committee I think he will be an absolutely first-rate partner for the Congress as you move to address the economic challenges which you, Mr. Chairman, and the other members of the Committee outlined at the beginning of this hearing.

Thank you again for the chance to come and be with you.

Chairman HARKIN. Well, thank you very much, Senator Sarbanes. Good to see you back, and I am sure we do not have any questions for all of you, but I just would say for the record that Mr. Gensler is indeed very fortunate to have three such well-respected and well-liked advocates for his position as the two sitting Senators and the previous Senator from the State of Maryland. Thank you all very much for being here.

Now I would like to call Mr. Gensler to the witness table.

Mr. Gensler, before you take your seat, if you would rise, we have an oath that we have to administer.

Mr. Gensler, do you swear to tell the truth, the whole truth, and nothing but the truth?

Mr. GENSLER. I do, Mr. Chairman.

Chairman HARKIN. And, Mr. Gensler, do you agree that, if confirmed, you will appear before any duly constituted committee of the Congress if asked?

Mr. GENSLER. I do, Mr. Chairman.

Chairman HARKIN. Thank you very much, Mr. Gensler. Please have a seat.

Mr. Gensler, welcome to the Committee. My congratulations on your nomination by the President, and we have your written statement. It will be made a part of the record in its entirety, and the floor is yours. You may proceed as you so desire.

TESTIMONY OF GARY GENSLER, NOMINEE TO BE CHAIRMAN AND COMMISSIONER OF THE COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Chairman Harkin, Ranking Member Chambliss, members of the Committee, thank you for the opportunity to appear here before you today. I am honored to be President Obama's nominee to be Chairman of the Commodity Futures Trading Commission at this critical time in the commodities markets, and for our Nation.

As a champion of the public's interest—for farmers, consumers, small businesses—the CFTC plays an essential role in our financial regulatory system and affects the lives of all Americans. And I firmly believe that strong, intelligent regulation with aggressive enforcement is what our economy needs and benefits the public.

The current economic crisis clearly has shown, though, that our financial and regulatory systems have failed the American public terribly. Those of us who have spent our time, our professional lives, around markets have to approach the current crisis with humility following such broad failures. We have learned the limits of our ability to foresee how markets may evolve. We have learned the importance of being candid with the American public about the risks we face and that we must be unceasingly vigilant to address these risks. We have also learned that there is no substitute for strong, independent regulation, that we must bring transparency and accountability throughout the system, and we must always err on the side of protecting the American public.

These are the lessons I draw from what has transpired this past decade. And, if confirmed, I pledge to this Committee and to the Congress that I will not forget these lessons.

We must repair our regulatory system by enacting much needed reforms that promote transparency, fairness, and safety.

If confirmed, I will fight hard on four essential priorities for reforming the commodities markets and our financial system.

First, the CFTC must vigorously fulfill its mandates: enforcing existing laws, promoting market integrity, preventing against fraud and manipulation, and guarding against excessive speculation. I will work tirelessly to ensure that the Commission leaves no stone unturned, ferreting out and putting to a stop activities and practices that hurt the American public.

I also look forward to working with Congress to provide the adequate resources for this agency which I believe currently lacks the sufficient funds to do even its current mission, let alone the missions I think it needs to take on.

Second, I believe that increased speculation in energy and agricultural products hurts American farmers and consumers and businesses. I do not have any doubt about that. A transparent and consistent playing field for all physical commodity futures should be

the foundation of our regulations. Position limits must be applied consistently across all markets, across all trading platforms, and exemption to them must be limited and well defined.

Third, we must now urgently develop a broad regulatory regime for over-the-counter derivatives. Standardized products need to be brought into mandated clearing and mandated exchanges. Beyond this, I believe the institutions themselves—the derivative dealers that make the markets in derivatives—need to have direct regulation under Federal statute, capital rules, business conduct reporting, and regulations need to be developed for customized swaps and for credit default swaps given their unique nature.

And, fourth, I believe the CFTC must work with Congress and other regulators around the globe to ensure that failures of the regulatory and financial systems, failures that the American people public has taken such a toll, never happen again. Now, this will not be easy. These are complex financial markets, and markets are irreversibly linked. But we will have to work with our global partners to make sure that around the world we have the same rules that we have here. This is the only way that Americans can really be protected.

Mr. Chairman, Ranking Member Chambliss, I am a proud believer in financial reform, tough regulation enforcement. I have been privileged to have had broad exposure to financial markets, here and in Asia, in public service and on Wall Street, as an investor advocate, and as a Government official.

And my experience has taught me the importance of having a strong working relationship with Congress. I appreciate Senator Sarbanes' comments on that. In these transformational times, I do believe we have a unique opportunity working together to bring bold and necessary reform forward. We must, though, take this opportunity to ensure we deliver on the expectations that all Americans have for us.

I would like to close by saying how much the support of my family—my three daughters—means to me, and the great sacrifices they will make if I am so honored to serve. My eldest, Anna, is a freshman at college and could not be here. My two other daughters, Lee and Isabel, if it would be appropriate, I would just like to introduce to the Committee.

Chairman HARKIN. Please introduce them.

Mr. GENSLER. This is Isabel, my youngest, who is 12, and then my daughter Lee, who is 17, who are here with us today.

Chairman HARKIN. Welcome to the Committee.

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, members of the Committee, I look forward to taking your questions.

[The prepared statement of Mr. Gensler can be found on page 43 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Gensler.

Mr. Gensler, in confirming nominees and moving their nominations forward, I like to know about their background and history and where they are now, their present views and outlook. Obviously, you have had experience, you have served in a previous administration. I would like to cover some of that with you as a way of examining where we were in the late 1990's and where we are today regarding issues under CFTCS jurisdiction.

On May the 18th, 1999, you testified before the House Agriculture Committee's Subcommittee covering risk management. In response to questioning by our distinguished ranking member, when he was a member of the House Agriculture Committee, you said you "positively, unambiguously" agreed with Mr. Larry Summers in his testimony to the Senate Agriculture Committee opposing additional regulation of the institutional over-the-counter derivatives market.

You went on to refer to the "vibrancy and importance" of the global over-the-counter derivatives market.

Here is a direct quotation. You said quote, "That large and vibrant market is part of, I believe, the American success. And we should recognize that and put the burden on those who are suggesting changes and further regulation, put the burden on them before we tamper on some of the successes of this marketplace for the economy."

Well, that is quite a resounding, unqualified, and categorical statement, no second thoughts or ambiguity.

Ms. Brooksley Born, who was about to leave as the Chairperson of the CFTC, had advocated strenuously over the previous few years, including before this Committee, that the risk of these over-the-counter derivatives needed to be evaluated and appropriately regulated.

However, you were part of the team arguing—and you can correct me if I am wrong on that—for a statutory enactment to take away all CFTC regulatory power over these over-the-counter derivatives. According to the Washington Post of October 15th, 2008, this team was really quite dismissive of Ms. Born, to the point of it kind of becoming personal at that time. But I do not need to go into that.

But this team was quite direct in advocating that these be exempted from CFTC regulation.

Mr. Gensler, what was your own personal role in dealing with Ms. Born during the time she was chair of the CFTC? Did you attend any meetings during that period of time in 1998 or 1999 or did you have any telephone calls or communications over that period of time with her? What was the nature of those interactions, and did you have any advice for her at that time?

Mr. GENSLER. Mr. Chairman, thank you for your question.

First, may I say, looking back now it is clear to me that all of us that were involved at the time—and certainly myself—should have done more to protect the American public through aggressive regulation, comprehensive regulation. We should have fought harder for some of the things that we raised with Congress at the time, whether that be regulating derivative dealers or keeping the oil and metals markets consistently regulated with the corn and wheat and soybean markets. These were things we recommended and we should have fought harder for.

I clearly look back on some things outside the jurisdiction of this Committee that I should have fought harder for, guarding against predatory lending practices.

I believe there are many things that at the time that we could not foresee, or did not see. They were just dots on the landscape,

as you, I believe, and other Senators here commented. And we have to do a far better job seeing that which is out on the horizon.

You asked specifically about meetings with Chairman Born and I recall working with her, working with her as a staff member at Treasury. I was an Assistant Secretary working on a report on long-term capital management and the after effects of the collapse of long-term capital management where there was a joint report put together in the spring of 1999.

During those earlier periods of 1998, when there was different views of the Treasury, the Federal Reserve, and the SEC from the CFTC, Ms. Born raised very good questions but I, in fact, at the time was recused because it did relate to a particular matter of my former employer. I had been at the full, big set piece President's Working Group meetings, as would be customary for the Assistant Secretary to attend, along with other staff of Treasury.

Chairman HARKIN. Well, Mr. Gensler, that is a very straightforward answer and I appreciate that. So would you say that your views and your thoughts on this have evolved and changed over the intervening years, looking back at what has happened in the last several years?

Mr. GENSLER. Mr. Chairman, I very much would say that my views have evolved. There is so much that has happened in the marketplace as electronic trading facilities, even that our exchanges now are public and for-profit enterprises and back then were not for-profit and public. And the financial crisis itself, to me, goes to the heart of some of the assumptions that I think collectively all of the Federal agencies and even Congress at the time grappled with.

I believe now it is just so important that we bring the whole over-the-counter derivatives marketplace on the market, into exchanges, as you do. I share that goal. And to also bring that over-the-counter derivatives marketplace onto centralized clearing.

I, frankly, though do not think that is enough. I also think we need regulation of the institutions, that Congress would actually have a statutory regime for derivative dealers, somewhat like we have for banks, where you have capital rules which address the excess leverage, have business conduct rules to make sure there is not fraud and manipulation in the sales practices. And then, of course, last and very importantly, reporting rules. These dealers—there is about 15 or 20 around the globe that make up 99 percent of the market for over-the-counter derivatives.

So I have come to believe strongly we need both, the market side, clearing and exchanges for the standardized products, the derivative dealers clearly regulated, all the information coming in.

Chairman HARKIN. I am going to follow that up in my second round because I want to ask about this whole idea of having some derivatives that are not on a regulated exchange. I will get to that.

In my reading, my memory but also my reading of that period of time from 1998 through about 2000, was that the President's Working Group was very forceful in their position that these OTC derivatives should be exempted from the CFTC. As I said, to the point one time where it also got personal with Ms. Born. I remember that.

And in my reading of it, about that, from various sources, it appears, of course, that you have some very strong personalities there. You have Mr. Greenspan, who was driving this, quite frankly. And he is a very forceful personality. He was driving this.

Then you have Mr. Summers. He is no shrinking violet, as we all know. He was driving this, also.

Then you have Mr. Rubin there, also. So you have a very forceful group.

CFTC was sort of shunted aside. Well, Mr. Gensler, should you get this position as the Chairman of the CFTC, you will be on the President's Working Group. And I needn't remind you that you will not be working for Mr. Geithner. You may be a friend of his; that is fine. You will not be working for him. You do not work for Mr. Summers. You do not work for Mr. Bernanke. You are the chairman of an independent regulatory agency. You do not even work for the President. You are chairman of an independent regulatory agency.

And as such, your views and your positions that you have should be that of a chairman of an independent agency. And one should not be reticent in advocating a position even to the extent that some of the other forceful personalities may not agree, if you get my point.

I just want some assurances from you that you will be that independent voice. Like I said, I am not asking you to sever friendships or the like. I am saying the mindset, the mindset of the Chairman of the CFTC cannot be working for Mr. Summers or Mr. Bernanke or Mr. Geithner or anybody else. And that you will bring that independent mindset to the President's Working Group.

Mr. GENSLER. Mr. Chairman, I thank you for that question. I think being Chairman of the CFTC is an independent regulatory agency. The commitment I give this Committee and to the American public that I will bring that independence. If I have a concern or thought about the regulatory protections that the American public needs, I will absolutely share it as one of the President's advisors, as part of the President's Working Group, with the President and senior members of his economic team.

But if we cannot reach any consensus and I believe something, I am going to bring it to this Committee, I am going to bring it to the American public. There is a real difference, in my mind, of being an Assistant Secretary of Treasury and being the chairman of an independent regulator.

I appreciate that when the President asked me—then President-Elect Obama—to be his nominee in December and we had a chance to chat, that was what he understood and that is what I understood, that I will certainly be advising the President. It would be a great honor to advise him on regulatory reform and all that we need.

But that which is at the core of my beliefs, that we have to bring the entire over-the-counter derivatives marketplace into a regulatory regime, these two pieces that I have talked about, these two big pieces I have talked about and the goals that we share, they have heard me saying this straight through since December 18th and they are going to keep hearing me say it. And I make that commitment to you, sir.

Chairman HARKIN. Thank you very much, Mr. Gensler. I will return to the issue of derivatives and trading on exchanges during the second round.

With that, I would of course yield to our distinguished ranking member, Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Mr. Gensler, in your statement you state, and I quote, "The current economic crisis clearly has shown that our financial and regulatory systems have failed the American people terribly."

I know you are very familiar with the workings of the CFTC. Surely you have followed the markets over the last several years since your direct involvement at Treasury. Is there anywhere that you think, or any particular instance you think where CFTC falls into that category of having failed the American people terribly?

Mr. GENSLER. Senator Chambliss, I think that the great failures are largely beyond the CFTC. But even in this area, the CFTC is, by Congress, that Act in 2000 that the Chairman referred to, asserted that they are an agency that has to look after systemic risk as well. And we clearly have had a systemic failure.

Second, though the CFTC, I do not think, has the tools to look after that much, I do believe that we have had speculation that contributed and hurt farmers and consumers and all Americans.

And if confirmed, I would fight hard to make sure that we have the resources and that we can bring what is needed to be borne to these markets within the current authorities at the CFTC.

Senator CHAMBLISS. With the current authority that is out there and the current resources that you are familiar with, do you think there is anything that the CFTC did not do that they should have done relative to this systemic risk issue that you are talking about?

Mr. GENSLER. Well, again, when the failure is so broad and complete, Senator, I just think all regulators have to look into themselves and say what could we have done differently? I do that personally, in terms of my own record.

I think that the CFTC has aggressively fought and tried to enforce fraud and manipulation in other areas. But if confirmed, I would certainly want to take a look at all of the individual hedge exemptions that are currently in place, some for 20 years or so. I think it is time to look back and see whether those exemptions are still appropriate, given the current times.

There are processes that the CFTC uses to allow for markets or individuals to take action sometimes that are not brought up to the full Commission level, and I think we need to do that, as well.

So these might sound like they are around the edges of a big financial calamity, but I think every agency needs to take a look to see what can we do better and what can we do more.

Senator CHAMBLISS. You and I talked about the potential for an SEC/CFTC merger that a lot of folks are advocating and have been advocating. And I noticed you are quoted, and I hope this is an accurate quote, "CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important task with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake."

I want to say that on the vital function of the CFTC, certainly you and I are very much in accord there. There has been much discussion about merging these two agencies, as well as the creation of a new systemic risk regulator to oversee all Federal financial regulators.

Personally, I have great reservation about bringing these two regulatory bodies together, as I expressed to you. For one, the SEC's performance in regulating their current portfolio has been less than stellar. And second, the CFTC uses principle-based regulation that has proven an effective approach to regulating commodity futures. It is difficult for me to see how welding these two regulators together will serve Americans well.

First, are you a proponent of the CFTC's principle-based regulatory approach? And if so will you, as Chairman of the CFTC, work to preserve this regulatory approach, as regulatory reforms and reshuffling of hureaucratic boxes are contemplated and proposed? And second, what problems could you see arising from an SEC/CFTC merger?

Mr. GENSLER. Senator Chambliss, I appreciated the time we spent in your office. I think we may have talked about this as well at that moment, too.

As I said, and that was an accurate quote, I think this financial crisis brings to bear so many other problems other than, as you say, the boxes. The CFTC was formed in 1974, hut really it was formed back in 1922 to protect the interest of—at that time—grain merchants and farmers so that they could appropriately and reliably hedge their risk in the future about their corn and wheat and then later soybean. And of course, we have added many other products to it.

I think that is fundamentally very different than what the SEC does. They are both market regulators. They both need to be strong on enforcement and anti-fraud and anti-manipulation, and look out for the public.

But at the core, the CFTC's mission about protecting farmers and merchants and later oil and metals, and though it has been expanded to financial products and it is critical to get the over-the-counter derivatives marketplace correct as well, is sort of around a different set of mission and goal than that which is the SEC.

I think both very vitally important. And as you rightfully point out, one of them principles-hased which, as Chairman of the CFTC, I would support and make sure it works. And if it did not work, I would be back here readily to work with Congress to see if we needed to fix something. And the Securities and Exchange Commission has another approach.

Senator CHAMBLISS. The 2000 Modernization Act was a very complicated piece of legislation that you were involved with back then, as were a number of us. We thought we were doing the right thing and I think we did absolutely the right thing by allowing the market to expand and putting more flexibility out there. As a result we saw these markets grow in a tremendous way. I think all of that has been healthy for the economy.

Obviously, as you alluded to, over the last 10 years—or well, 9 years we have seen major changes in the industry. We have seen

very volatile prices from time to time which can be attributed to any number of issues.

But my question to you is looking back at the 2000 Act, and knowing what you knew then, is there any recommendation that you think was made that we did not follow that should have been followed that we ought to think about now? Or do you think that act worked the way that all of us intended for it to at that time?

Mr. GENSLER. Well, I believe, looking back now, knowing what we know now, there are two areas that we did raise then but we should have fought harder for, I personally felt—thank you, Senator—should have fought harder for.

One was the concept of regulating the dealers themselves, the brokers, the voice brokers or derivative dealers that are making markets. We all know their names. I will not name them here, but the large financial institutions.

We recommended that. In some cases, they were the affiliates of the broker-dealers. But one of the big lessons out of AIG, the insurance company that failed, they had an unregulated dealer in the derivatives business. And now, in that case, it was \$450 billion in size. In that case, it was largely credit default swaps. But it was also unregulated. There was no, not the New York State Insurance Commissioner, nor any Federal regulation about its capital, its business conduct, its reporting. I think we need to put that in place.

Second, at the time the President's Working Group did suggest and recommend that oil and metals and cotton and wheat all have a consistent regulatory regime. We were unable to achieve that, working with the various committees in Congress in working that through.

But I think that is a good foundation. I still think that is the right foundation, that if something has finite supply and is more easily manipulated, that we should think of consistent regulation and make sure that we get that in.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss.

Senator LUGAR.

Senator LUGAR. Thank you, Mr. Chairman.

You have just mentioned, Mr. Gensler, the ideal of having the agricultural commodities but likewise, a broader group together. Certainly in testimony that we heard in October and before many advisors, even to pension funds and to college endowment funds, suggested a grouping of commodities which included corn and soybeans but also metals and oil and these combinations of commodities that serve those interests well for a period of time.

But it did lead to an interesting question with regard to regulation of them, and it is a discussion that we had at the time of the reauthorization of CFTC a while back which, without going into who was for and against, the problem of the regulation of oil, for example, or of various other energy products, was fiercely resisted by some Senators, by some witnesses, by some members of the Administration at the time, as I recall.

I mention that now because I really want your judgment as to what should be the scope of the CFTC? We think about the agricultural scene, that seems fairly clear. It has never been quite that

clear with regards to other commodities, as they are thought of generally.

What sort of scope do you envision as ideal, in terms of a regulatory regime?

Mr. GENSLER. Senator, I thank you for the question and I thank you for having—we had a good meeting together on these subjects.

I think that the Commodity Futures Trading Commission currently has exclusive jurisdiction from Congress to regulate the futures markets. And it has proven well, as Senator Chambliss said, though in the midst of a crisis everybody has to look within. It has proven well in regulating over these 35 years the futures markets.

I believe that if we are able to bring over-the-counter derivatives into centralized clearing, into exchanges for these products, that the CFTC is best situated with expertise on the derivatives marketplace, if appropriately funded I must add. But I think they are best situated amongst the Federal regulators for these authorities.

Senator LUGAR. Now the appropriately funded point which you touched upon in your opening remarks, and which has often been touched upon by the leadership of the Commission, just has not been occurring. There is not an understanding I think, perhaps, of the scope of what this means if you are to take in all of the different types of derivative contracts and various other situations.

From the beginning will you be able to give the Committee and work with us in terms of how many people you actually need or what sort of facilities are required to achieve something which the American people clearly want at this point?

Mr. GENSLER. Senator Lugar, I look forward, if confirmed, working with you and the Committee on that. I know under its current authorities the CFTC has just under 500 people. This is the same size it was in 1974.

Senator LUGAR. Yes.

Mr. GENSLER. So in 35 years, when the markets have grown more than 50-fold—again, markets have grown 50-fold, the agency is the same size. That is either efficiency or well, or it is underfunded. And maybe it is some of both, but I think it is underfunded.

It was 600 people just a few years ago. The enforcement arm had 150 lawyers, it is now only 110 lawyers, just to enforce the laws currently in place.

I believe the Agency has put a request in, and I am a private citizen but I was able to read this letter in the last few days, to get back up to 690 people. That gives you a sense of what they believe right now they need.

Senator LUGAR. I think it is probably incumbent upon us, but you if confirmed, to gain greater recognition for what the CFTC does. I think it has always remained in the shadows. But no longer. We have a financial crisis that still goes on.

Let me add one further thought, as you are thinking about the budgets. I have no idea what the result will be of our debates on energy resources, climate change. But let us say that a cap and trade system was established in this country in which there was really a very conspicuous and very expensive market for carbon.

I ask sort of in advance what your judgment would be as to whether the CFTC should be the agency that regulates huge sums

that are likely to be involved if a very serious cap and trade situation involving all of our industries, utility, so forth, was to come about?

Mr. GENSLER. Senator Lugar, I believe under the current statutory authorities that the CFTC does have that oversight, and there is a very small cap and trade market now I am told, regional market, that they have some oversight.

Senator LUGAR. Yes.

Mr. GENSLER. If that were to grow into a national market, he listed on an exchange or in other ways, the CFTC, I have been told in my early investigation, does have that authority. But I would certainly look forward to working with Congress if we need to put more of that into statute and address that specifically.

Senator LUGAR. Let me just ask as a personal inquiry, I have become a member of the Chicago Climate Exchange, largely as a demonstration that farmers who have hardwood trees and have proper measurement and so forth are sequestering carbon in their trees. And each year we have an update of how much more is there.

So on the website of the Chicago Climate Exchange, every day there is a quote for their price of a ton of carbon. It is \$1.95 today. It was up to \$7 at one point during the year.

Similar situations in Europe, however, have had quotes of anywhere from \$20 to \$50 per ton, depending on the Kyoto Protocol and how seriously some countries looked at this.

I mention this because there is, as you say, a modest attempt being made by people in Chicago, who also are working with the Europeans in this. And it may come to pass that the Congress debates this issue but puts it aside, as was the case last year.

But if we do not put it aside, this is going to be a very, very large set of problems and sums of money and implications for something well beyond agriculture or speculators in commodities. And that is why I wanted to try to establish who is responsible. And your judgment, and I agree with it, is that it is the CFTC.

But having the personnel, the regulations, the rest of it for this is sort of a quantum leap and is the type of thing which hopefully we will not look back in a hearing 10 years later and say why did we have no vision, no preparation, and no people.

Mr. GENSLER. Right. And Senator, I think you raise a very good point. The Commodity Futures Trading Commission has the best experience and background and current authorities regulating the futures markets.

But just as it does also work with the Department of Agriculture that has the best authorities and expertise on agriculture and the cash markets and so forth. So there is some shared protection of the American public between the Department of Agriculture and the CFTC in corn and wheat and other products, where the CFTC is focused on the futures.

There may well be multiple agencies in a cap and trade situation where the CFTC brings its expertise to protect the American public in the futures markets and other agencies bring their expertise to protect the public in other regards.

Senator LUGAR. Thank you.

Chairman HARKIN. Thank you, Senator Lugar.

Senator Stabenow.

Senator STABENOW. Thank you very much, Mr. Chairman.

First of all, welcome and I look forward to supporting your nomination.

Mr. GENSLER. Thank you, Senator.

Senator STABENOW. Is this microphone on? It is not working. Well, I am going to move over here, just a second. We will see if this one works.

OK, that is working, and I am not Senator Conrad.

Welcome again, and I will say for the record, with the microphone on, I look forward to supporting your nomination on the floor and to working with you.

I wanted to follow up with Senator Lugar, I think, what Senator Lugar was speaking about, the engines of cap and trade, which I think is such an important new area for us to focus on. President Obama spoke about it last night. We know that there is a lot of work being done, important work, being done to craft the right kind of balance for moving forward to tackle this issue, which I hope we will do.

And some believe this will create the largest derivative market in the world. So there are a number of questions that I have in terms of how we approach this. It is a real opportunity, I think, to design a transparent, efficient, carbon market that builds on the practices for market regulation that we have.

So I am wondering what you believe the lessons are that we have learned from other financial markets that would guide us, guide Congress and Federal regulators as we design a new carbon market?

Mr. GENSLER. Senator, first let me thank you for the support and confidence you have in me in this nomination, and that means a great deal to me.

As I indicated, the carbon markets and the cap and trade markets may grow. The CFTC does have expertise in terms of the futures markets. And though I have not studied these issues in any depth, let me just mention a couple of things.

I think that it is important, just as in other futures markets, to make sure that we have a transparent marketplace. So if there is a design of a contract, as there is design of contracts in corn and wheat and oil and so forth, design of contracts that there is some transparency and there is a marketplace where it trades, there the public can see and corporations can see that marketplace and have the benefit of that transparency. And that there really are protections, just as there are in other futures, from fraud and manipulation.

But there may be things that are specific to this market that I, if confirmed, would look forward to working with you and your staff and this committee to better understand and better advise you as you go forward.

Senator STABENOW. Thank you.

This may be something, as well, that you have not focused on specifically regarding carbon. But there is another issue related to that which relates to bonafide hedgers and what is a bonafide hedger in this context. And I would be interested in knowing if you have any thoughts on a definition or what the CFTC and the Con-

gress should do relative to this issue when we think about the nascent carbon market.

Mr. GENSLER. Senator, I think that all of the markets that the CFTC has oversight for, futures markets and hopefully these other over-the-counter derivatives, where there is something of finite supply, it is susceptible, that underlying product is susceptible to both manipulation, corners—what is called corners and squeezes. I am old enough to remember when the Hunt brothers cornered the silver market. I know the lack of hair, but I remember that.

And I am not familiar enough with the carbon markets, but I think that is probably a market that would fall into this category which is susceptible to some finite supply.

And also, the position limits are critical to protect against excess speculation. Hedgers need the benefit of speculators on the other side. We have had, for 130-plus years, contracts in the futures market and hedgers want somebody on the other side to take a risk. But there is a burden if it gets so excessive, and we saw that volatility in the last several years.

So I think as it relates to this new market, the lessons of guarding against manipulation, guarding against excessive speculation would inform me, as Chairman if confirmed, and quite possibly inform Congress as to thinking about a regime in the carbon market, as well.

Senator STABENOW. Thank you. I look forward to working with you on this issue. We have a number of different discussions we need to have that relate to regulating carbon, how this is going to be done in a transparent way, how there is accountability, how we—again, as you indicated, make sure that we are doing everything we can to deal with speculation in the marketplace driving up costs and so on.

So I think there is a very important opportunity and role going forward for the CFTC in this whole discussion, and what I hope will end up being a strategy for us to be able to address the issue of carbon and cap and trade.

Mr. GENSLER. Senator, if confirmed, I look forward to working with you on that.

Senator STABENOW. Thank you.

Chairman HARKIN. Thank you very much, Senator Stabenow.

Mr. Gensler, I had this chart prepared here. No, I am not Senator Conrad.

[Laughter.]

Chairman HARKIN. He sits right there. That is an inside joke referring to Senator Conrad's use of charts.

But this is the oil market from 1997, here is 2007, and here is the price spike of last year coming back down here to about \$40, maybe a little bit less than \$40 a barrel right now, somewhere in that neighborhood. So the consumers see this and they suspect something is wrong with this big spike. There really wasn't less oil. In fact, if anything, we were beginning to see the situation improve in Iraq, and Iraq has significant oil reserves. So it really wasn't a lack of a supply.

So if these wild price swings are not a function of normal market factors, how is that explained to the public? As Chairman of the

CFTC, how would you explain something like this to the public that happened last year in oil? How would you explain that?

Mr. GENSLER. Mr. Chairman, I think that we had an asset bubble in the oil markets, an asset bubble even in other commodity markets. To the American public, I would say, as we saw—

Chairman HARKIN. Explain that asset bubble as it regards this.

Mr. GENSLER. Well, similar to in the housing market, but driven by different factors, but just as the housing market, housing prices went up beyond what one might have said was the underlying cost to build the homes and so forth. In this marketplace, I believe that we had a great many people come to the conclusion that it is another asset class. The stock market is someplace you can invest. Maybe the bond market is someplace you can invest. Now the commodity markets is a third place one might invest to diversify risk, and there are great theories of diversification and theories I generally believe in.

But that risk diversification led some investors to try to invest in commodities and I think over this period, just before the run-up, but over the period from 2004 to 2007, that some statistics that I saw, that increase of outside investors, and I have said publicly and I will say again here I believe that investors that were investing as an asset class, whether they were index investors or hedge funds or other financial investors around the globe, not just here, had the perception that this price was just going to keep going up so that the—they were wrong. They were terribly wrong. But as a factor in that, the American public was hurt. I mean, it was terribly hurt by this speculative bubble.

Chairman HARKIN. So I could substitute speculators for the word “investors.” You use the word “investors,” but they were speculators. They were speculating on this market continuing to go up all the time.

Mr. GENSLER. That is true, like some people speculated on home values or some people speculated on real estate or other things.

Chairman HARKIN. This is something that I have wrestled with since I first came here in 1975 to the House Agriculture Committee and that is the role of speculators. The term speculator has a bad connotation. So what is the proper role for a speculator in a market? I don’t care whether it is oil, it can be grains, it can be metals. What is the proper role? Is it beneficial? And how do you explain to the consuming public, most of whom, if you ask them should speculators be driven from the market, would say yes—nine out of ten, I bet, would say that—so how do you explain, what is the beneficial role of speculators?

Mr. GENSLER. I think at the history and the core of the futures markets, going back to the 1870’s, in fact, when a farmer wanted to have a reliable price for corn or wheat that they might want to sell at the end of the harvest and know how much money they would have to plant their fields, on the other side of that transaction, there needed to be somebody who was willing to bear risk, almost like writing insurance.

So for 130 years, since futures started trading, we have had a concept, and I believe it to be the right one, sir, where commercial interests, farmers, ranchers, and then later oil producers and natural gas companies and grain elevators and so forth, all wanted to

have a reliable price for their product so that they can make business decisions. Well, on the other side, then there is somebody in essence writing—taking on that risk. It is not an insurance company. In fact, it is somebody we call a speculator, somebody who is taking a position on the other side.

What is at the heart of the CFTC authorities dating back to its founding is that that is to be allowed, but we also want to protect against excessive speculation and the burdens of excessive speculation, and there is a whole regime of position limits to limit that, and there is also clearly an important public interest to protect the American public against manipulation in markets. And sometimes when you see spikes like this, you say it broke down. What was happening may have broken down.

Chairman HARKIN. Could the CFTC have started to do something in here to stop that speculative bubble in oil prices?

Mr. GENSLER. I believe that all of these products need a consistent regime of position limits and those position limits should apply around the globe. The CFTC, in working with Congress, has addressed a number of these features. In the farm bill last year, I believe, to the credit of this committee, working with other members of the Senate and the House, you put in place a way to close part of that. There is also things that the CFTC has done subsequently, working with the regulators in London to try to address some limits so there is more transparency and that limits, where they are in place, apply to all markets consistently around the globe.

Chairman HARKIN. Well, at least with the oil market, you could see it happening. But I would like to turn, if I could, to over-the-counter derivatives, which really is an opaque market and which you can't see happening. First of all, would you agree or slightly agree or disagree with the statement that derivatives are more like futures contracts than just about anything else. Is a derivative a futures contract?

Mr. GENSLER. Senator, a future is actually technically a derivative. A derivative is just a broader term, and I believe that all of these products have great similarity. So I think that hopefully answers the question. And what they have similarities is that they derive their value from some other product. A future derives its value from the corn or wheat or—

Chairman HARKIN. That is a future. That is right.

Mr. GENSLER. That is a future, and an over-the-counter derivative derives its value possibly also from corn or wheat or oil or it might be from underlying interest rates. So they are very similar products. They are all forms of financial instruments that derive their value from some underlying feature.

Chairman HARKIN. OK. And a derivative's value basically depends on something happening in the future. A derivative is tied to something either happening or not happening in the future. So I always think of derivatives trading as a futures market. So, therefore, why should they be exempted? Why should they be exempted from the CFTC?

Mr. GENSLER. Mr. Chairman, I believe that the entire over-the-counter derivatives marketplace, we need to bring those standardized products onto centralized clearing, and we get a great benefit

from centralized clearing and we will lower the risk in the system and add to transparency. We actually attempted to do some of this 8 years ago and there was a voluntary clearing mechanism that was in that bill. I believe now it should be mandated for interest rate product, currency product, commodity product, credit default swaps, and the equity products, the whole regime.

I also think the standardized products, we get great benefit from the transparency that can come from being on exchanges. There are some exchanges for these derivative products, but we can get a great deal more benefit from transparency from bringing those standardized products onto exchanges.

Chairman HARKIN. Help me think through this. I have a concern that you keep using the word "standardized," and I saw that in your response to questions asked of you by both Senator Cantwell and Senator Levin. And you referred to it a number of times here, about the standardized credit default swaps for example, standardize.

But it seems to me that if someone wanted to trade in an over-the-counter derivative market and not on a regulated exchange, they could simply do little things to make the contract customized, and you can't, in all your wisdom, define every little thing that could make it a customized rather than just a standardized swap or derivative. So how can you have both a regulated exchange for standardized, and then an over-the-counter for customized? How do you define what is custom?

Mr. GENSLER. Mr. Chairman, I couldn't agree with you more. I believe that is why we also need, working with Congress, to come up with a regime for the customized product. There is still commercial interest, whether they be a grain elevator or it can be an airline that wants a certain grade of jet fuel delivered on a certain day to a certain airport, and those dates and that grade of jet fuel and that airport may be different than a particular contract. That is customized.

But at the same time, if we bring reporting to that and required reporting, required capital or margin requirements, and we level the playing field between that and what might be the standardized products, I believe that working together still allows the legitimate commercial interest to try to hedge in that little example a particular jet fuel at a particular date at a particular airport.

Chairman HARKIN. Maybe there is something here I don't understand, because I have thought about this a lot and I have read a lot about it. But it just seems to me that if you are going to close the loophole, you have got to put them all on a regulated change. If someone says they have got a custom deal, well, put it on the exchange anyway. Then we know what you are doing.

Many thousands of contracts would avoid daylight by one little custom change. I have said before, if you and I want to swap something, you want to swap your tie for my tie, no one else cares. But if you own a whole portfolio of stocks and bonds and you want to swap that for my little piece of land someplace that may have tenants on it and things like that, well, then you see a lot of other people are involved in that custom swap.

And I am thinking, why not just put those on a regulated exchange? And if you can't do that, well, then you are just—you just

outlaw those customized kind of swaps unless they are willing to put them on a regulated exchange.

Mr. GENSLER. Mr. Chairman, that is why actually I believe that we, in addition to what we are talking about, also bring a full regulatory regime to the dealers themselves, these large financial actors that deal in these markets. My fear, Mr. Chairman, of saying they are outlawed entirely is not only that which might hurt, whether it is a grain elevator in Iowa or whether it is an airline that wants a certain jet fuel on a certain date in a certain city, that they will find some other way. That is true economics. An airline wants to hedge that risk some other way that is then outside of the regime.

So I think working with Congress, if confirmed, I would look forward to making sure that 100 percent is reported, that it is not opaque, that it is all brought in and aggregated into central data warehouses, which I know a number of Members of Congress have looked at and worked on, that there is no hole in the bottom of the boat that it all flows out of, but that the hundreds of products and the great majority of the products that are standardized are on exchanges, and if an exchange accepts it on the exchange, it has got to be on the exchange. And if the clearinghouse accepts it in the clearinghouse, it has to be in the clearinghouse.

But we still—like you said, if we swap ties—and I do like your tie—but if we swap ties, Mr. Chairman, that it might well be that that has to be reported and we have to have capital charges for it but not have that on an exchange.

Chairman HARKIN. I see Senator Klobuchar is here and I am going to yield to her. I have more to go into on the topic in a little more depth, but it just seems that once you have an over-the-counter market, derivative market for customized contracts, you can just about exempt anything. If I have a futures market that says the expiration date is July 20, but then I say, no, I need July 21, does that make it a custom contract? Does that exempt it from exchange trading? That is what I mean. It just seems to me I can make any little change and all of a sudden I am exempt and can trade the contract over-the-counter.

Now, you say, well, you report the trading anyway and so forth, but I am still not certain that gets to the nub of the benefit of putting the trade on that regulated change where every day it is transparent. One can know exactly what is happening and you don't have these customized things drifting around out in the OTC market. I think you just open the door for proliferation of inadequately regulated OTC trading.

Mr. GENSLER. Mr. Chairman, you and I share exactly the same goal, that we bring this whole marketplace into what I believe is two regimes. One regime is the centralized clearing in the marketplaces. The other regime is that the dealers themselves have serious regulation on capital, business conduct, and reporting, and that we rely on both to bring a marketplace that is very important and large into our economy, but under regulation.

Chairman HARKIN. Thank you very much, Mr. Gensler.

Senator Klobuchar?

Senator KLOBUCHAR. Thank you very much, Mr. Chairman. We will have to leave the tie swap idea behind because I don't have one.

Mr. GENSLER. Thank you, Senator.

Senator KLOBUCHAR. But I wanted to congratulate you on your nomination. I appreciate, Mr. Chairman, that this nomination hearing was held in such a timely manner, given what we are facing here, how important it is, and that we need a cop on the beat to monitor commodity trading and giving us good advice about what to do with financial derivatives.

I just noticed that the President at this very moment is holding a press conference on financial regulations and what he thinks needs to be done here. I have been just stunned by everything that has gone on here. I remember your predecessor, Mr. Lukken, when he appeared before our committee, and as a former prosecutor, I was giving him some ideas of the things that I thought maybe we could give to him as tools to use to improve things.

We talked about staff improvements, which I think is important, or additional staff. But then we talked about this idea of more tools and he actually said, no, he didn't want that tool. No, he didn't want this tool. We talked about the London loophole or would he like more ability to go after certain things, and he said that he didn't want that ability.

I said, you know, as a prosecutor, you want—if you think a statute will help you with a certain group but you are not sure if you are going to use it, you still might want that statute. I just wonder how you would respond to that, because that is what most stunned me about that hearing.

Mr. GENSLER. Senator, thank you for asking the question and taking the time at this hearing in your busy schedule. I absolutely believe the CFTC needs more tools, unambiguously. I believe it has to be a tough cop on the beat and strong on enforcement. We need more resources to do that. I mentioned to some others that the enforcement wing itself has 150 lawyers, was shrunk to 110. This is in a period of time that the futures markets went up sixfold in volume, in the last 8 years.

But beyond that, I believe that we do, working with Congress, have a broad agenda, if I am confirmed, to try to get additional authorities to address some of the very real issues in the agriculture and energy markets and the over-the-counter markets to control some of the excesses that we have seen.

Senator KLOBUCHAR. Well, one of the things we talked about last year was closing the so-called London loophole, to stop traders from routing transactions through offshore markets to get around limits on speculation. I worked with Senator Dorgan and a lot of others on this speculation issue. Do you think that would be helpful?

Mr. GENSLER. Senator, I do. I congratulate your efforts on that. I think that the CFTC has done some things administratively, but I think it would be very helpful, working with Congress, if confirmed, to actually have that in statute. And it is really—the core principle I would have is that markets are so interlinked around the globe that if it affects American consumers, that we should make sure, even though we might have reciprocal arrangements with other regulators around the globe, that fraud and manipulation, that position limits and reporting have some consistent regime. And so I would look forward to working together on that and

I do believe it is important to have these position limits apply to various trading platforms around the globe.

Senator KLOBUCHAR. You know, credit default swaps have been blamed for helping to accelerate the over-leveraging on Wall Street. Do you share this view and do you think that something should be done about this?

Mr. GENSLER. Senator, I believe a great deal needs to be done with regard to the over-the-counter derivatives marketplace, not just credit default swaps but, as the Chairman and I were discussing as you came in, to bring the whole over-the-counter derivatives marketplace into a regulatory regime with centralized clearing and exchanges.

Senator KLOBUCHAR. Right.

Mr. GENSLER. But beyond that, I do think credit default swaps raise an additional set of unique challenges. In AIG, we saw a book of business that wasn't even regulated. The transactions weren't and the financial institution wasn't. I am recommending that those should be regulated, and the credit default swaps' unique properties, because often they are very much like a corporate bond and it is a corporate bond with a lot of leverage in it. And I believe that regulators need there to work together to find the appropriate controls in addition to clearing and exchanges. I think there is appropriate further regulation in that market that is needed.

Senator KLOBUCHAR. Good. One last question, following up with the last questions that the Chairman was asking with the custom issue. Last September, the CFTC issued a report on the over-the-counter markets and it contained some recommendations, and one important recommendation was to create enforceable position limits by developing limited risk management exemptions for swap dealers and requiring dealers to, first of all, report to the CFTC about large customer positions, and second, certify that none of the non-commercial customers exceeded specific position limits in related exchange trading contracts.

Do you support this action? Do you think that this is a recommendation, and should that rulemaking activity continue?

Mr. GENSLER. Senator, I do, but even further, as I understand it, and again, I look forward to learning more about this, if confirmed, but these various position limits that are at the heart of the framework to comply with the mission of this agency have some exemption that have been issued going back nearly 20 years. Many of them were issued by staff, "no action" letters. I believe that every one of those exemptions needs to be reviewed. As Chairman, I would be looking forward to working with my fellow Commissioners, Mike Dunn and Bart Chilton, Jill Sommers, Walt Lukken, and really take a look at all of these.

And second, also look at the process of issuing "no action" letters themselves. Some should stay at staff level. But others really are consequential and that is why you have Senate-confirmed people in the jobs to look at these things.

Senator KLOBUCHAR. OK. Thank you very much. I appreciate it.

Mr. GENSLER. Thank you, Senator.

Chairman HARKIN. Thank you, Senator Klobuchar.

Senator Chambliss.

Senator CHAMBLISS. Thank you. If I could go back to the Chairman's chart there for a minute, Mr. Gensler, and I want to see if I can ask this question the right way. I don't want to take your language and interpret it in some way other than exactly what you meant. But when you talk about the spikes in the market and you talk about speculators causing that huge spike, is it not a fair statement to say that speculators who sought to manipulate the market are the ones that may have influenced that spike versus speculators per se causing that spike?

Mr. GENSLER. I think that what I believe is that there are many contributing factors, that we have had in our economy and around the globe many imbalances, low savings rates here, very high savings rates, nearly 40 percent saving rate in China. There are great global imbalances that have been flooding into markets.

Within those global imbalances, I believe that commodities started to be viewed as an asset class for investment. And so one of the contributing factors—there were other contributing factors, too, but one of the contributive factors, I think, is as investors started to look at commodities as an asset class, and unfortunately, over the globe, risk was underappreciated, terribly underappreciated, and when I say that, I mean it was underpriced.

There were too many investors, and, yes, speculators who thought it was more likely that something would go up than down, that the demand factors from China and India or the low refining capacity would keep pushing these prices up. And that collective misjudgment of market participants is what I think you see there, but not necessarily—I don't have the facts or figures to say that it was manipulation, sir.

Senator CHAMBLISS. You made a statement which I think is correct and which I have argued with my colleagues who would like to see all speculators eliminated. Are you going to have a market that functions properly without speculators?

Mr. GENSLER. Senator, again, I think at the heart of the futures market since the first contracts, I believe, were put in place in the 1870's is that for a hedger to have somebody on the other side who is willing to bear that risk, we call the person on the other side a speculator. We need—the markets need that so that the commercial interests, the farmer, the rancher, the grain merchant, has somebody on the other side to bear that risk.

Senator CHAMBLISS. And you have been on both sides of this. You have been on the investment side as well as on the regulatory side. You have got extensive experience on both sides. If an investor in the market, somebody who trades in the market regularly, is overregulated, including adding position limits, and they have the availability of going offshore, what is that person as an investor who feels like he is overregulated going to do with respect to the American market that CFTC regulates versus trading offshore?

Mr. GENSLER. Senator, I believe these markets are completely interlinked at this stage. So I think that it is critical that the U.S. regulators work with our global counterparties in Europe and in Asia to assure ourselves that there is consistent regulation. And where we are unable to get that consistent regulation, to work still to protect the American public the best we can as to the transactions with the American public, or where there is American prod-

uct, a product like West Texas intermediate, or products that are right here.

But I agree with you, sir, that paramount is working with the global regulators. I believe that we can find that consensus. But if confirmed, I know there will be challenges to hopefully make sure it is around the globe.

Senator CHAMBLISS. Well, if you are an investor, whether you sit in Washington or New York or Atlanta, and you want to buy a contract of a product that is sold internationally or on a market that is regulated by CFTC and you have got the choice of where to go to buy that, as an investor, are you going to look for a market that gives you the greatest amount of flexibility and therefore the greatest opportunity and a safe way to ensure a profit, or are you going to go to a market that just overregulates you to death?

Mr. GENSLER. Senator, I think that investors in these markets are so interlinked that they will find a fungible place to go, and that is why, if confirmed, my commitment to you is to, first, to raise with you and the rest of the administration what rules I think will best protect the American public, but then second to work feverishly with international regulators to try to see if they agree, and where we agree, hopefully adopt a consistent regime. Where there are disagreements, at least come back to this Congress and the administration, because those differences will possibly be important. Hopefully, those differences won't be, but they may be really important to the American public.

Senator CHAMBLISS. Well, I think all of us want to make sure that the American public is totally protected and make sure that anybody who invests in the market is going to have the assurance that somebody is looking over their shoulder. But the fact is that these markets are traded on by individuals who are extremely sophisticated, and as you said, things have changed so much over the last 9 years. Gosh, we didn't have electronic trading back then, and now, very few trades probably are not in some way not connected to the electronic side of it.

And I know from talking to traders who have told me, look, you start putting position limits on me, pure and simple, hey, I can trade on the London Exchange from Atlanta just like I can trade on ICE or CME or New York Exchange, and that is what we will do. I just want to make sure that there is a clear understanding that we can go too far and we have got to be careful about that.

Mr. GENSLER. And I think that, Senator, you and this committee and the rest of this Congress worked last year, as I understand, in the farm bill to say contracts that look like the contracts here—they are called look-alike contracts—that had a particular relevance to these markets here, those were the ones that position limits.

There may be other contracts overseas that really are on other markets involving other products. But where it really was sort of almost like twins, those look-alike contracts, it was appropriate to have consistent regulation. But I certainly, if confirmed, understand it, as you say. I think that my experience both on Wall Street and in government provides a certain background to understand, exactly as you said, that we have to get this right.

Senator CHAMBLISS. With respect to the standardization of products versus the customized products out there, I think if I heard you correct, you say that there ought to be a clearinghouse for the standardized products. But you and I, I think, agree that we have got to be very careful with the customized products because I am not sure how you do that, how you are going to have a clearinghouse for all customized products.

I know one thing that has concerned some of my colleagues is that the way we all know these markets work are that a customized product may change hands two or three, four, five, ten times in one single day, and how in the world we are going to clear all of those in a manner that has a regulator looking over their shoulder, I don't know. I am concerned about those types of contracts certainly going overseas.

But am I wrong in my thinking somehow? Is there some way that you think that we can come up with a regulatory process that not only is a clearinghouse for the standardized product, but the customized product, also?

Mr. GENSLER. I do, Senator. I know these are very complex markets and these are challenges, but I do, and I think that there can be a product that changes hands multiple times a day is probably, with all respect, more standardized than customized. There has been a number of approaches, I know both here in the Senate and the House and some draft bills on how to define what might be customized.

But centralized clearing adds a great benefit because it means that these individual financial institutions, these 15 or 20 large financial institutions, are no longer exposed to each other. And one of the great calamities of this past crisis is that one financial institution couldn't fail because if it failed, it was like interconnected, so interwoven that it was going to bring down the whole system.

One of the big benefits of centralized clearing is that all of these trades, rather than with each other, is with a central mechanism, and there would be a posting, like on the futures exchanges, a posting of collateral on a regular basis. AIG, when it got the call, had to post \$40 billion of collateral. Well, we know what happened then. The U.S. taxpayers stepped in and loaned the money to AIG.

I believe we really have to work feverishly and urgently to try to make sure that doesn't happen again. I think that centralized clearing, I think the bias that I am suggesting is toward getting those contracts in, and if a clearing mechanism, and there are a number of competing clearing mechanisms, but if a clearing mechanism would accept a contract, that is certainly one test it should be there, and then Congress can also dictate certain rules. I mean, there is a lot that we would need to work together, if confirmed, on how to structure this. But I do think it does help lower the risk tremendously.

Senator CHAMBLISS. The "no action" letter, would you support elimination of "no action" letters, or do you support still utilizing the "no action" letter process in appropriate situations?

Mr. GENSLER. As I have come to understand it, all of the major regulatory agencies, whether it is the FTC or the SEC, CFTC, has a form of "no action" letters. There are some things that are truly

administrative and staff writes a letter and says they are not taking an action.

What I believe we need to do at the CFTC, working with the other Commissioners, is really look at that process and see how is that done and which ones are consequential and which should come up to the full Commission, a five-member Senate-confirmed Commission. So I believe at the end, there would still be some that are really truly either administrative or ministerial or consistent with role, but there are consequential ones, I believe looking now in hindsight, and hindsight is—I know we are foresight here, but I believe that we need probably to really look at which ones come up to the full Commission for their consideration.

Senator CHAMBLISS. Last, let me just say, I think Senator Lugar had a really good point. Even in Math 101 at the University of Georgia, they taught me that if you can buy something for \$1.96 in the United States and take it to Europe and sell it for \$20, that is a pretty good deal.

I can envision 10 years down the road, if we have a true cap on trade system, we are going to see these things traded on a global market. So I just say that is something that has got to be in your line of thinking here as we go through the next 12 months, 24 months, whatever it may be, if something does come out of Congress in that respect, because, gee whiz, you talk about electronic trading being a milestone. This is going to overwhelm us, it would look like to me, with this international cap in trade system that we potentially have out there.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Chambliss.

We have been joined by our distinguished colleague from North Dakota, Senator Conrad.

Senator CONRAD. Thank you so much, Mr. Chairman and Ranking Member Chambliss. Thank you, Mr. Gensler, for being here.

I was here earlier and had to go to—you know how this place is—other obligations. I very much apologize for not being here for the rest of the hearing. I was so struck by having Senator Mikulski, Senator Cardin, and one of my all time favorites, Senator Sarbanes, here, and it reminded me of my favorite story about Senator Sarbanes, who was a great baseball player in his youth.

Mr. GENSLER. He was. He was. Not a lot of people know that, but it is true.

Senator CONRAD. Yes, he was a terrific athlete. He was selected for the Maryland All-Star Team as a shortstop, and he went to the practices and it came time for the game and he was listed as starting at second base. And he went to the coach and he said, "Why is it that I am at second base? I was chosen as the shortstop." And the coach said, "Kaline will be playing shortstop."

[Laughter.]

Senator CONRAD. That was Al Kaline. And I thought, that is a great story, isn't it?

Mr. GENSLER. It is terrific.

Senator CONRAD. Sarbanes had to stand aside for Al Kaline.

Well, you, in essence, are coming into the big leagues, too, and this is a different kind of big leagues. Our country and our world are in very serious shape. I just spoke to a group from back home

talking about how we got in the situation we are in, and I believe it is a combination of a very loose monetary policy, a very loose fiscal policy, a very loose trade policy, all coupled with deregulation, that created the seed bed for bubbles to form. And we didn't get just a housing bubble. We got an energy bubble. We got a commodity bubble. And when those bubbles burst, it did enormous damage. There is a lot of wreckage here. And all of us have responsibilities.

While I fought against what I thought was a very dangerous fiscal policy and a dangerous trade policy, I, along with others of my colleagues, voted for the Modernization Act, which you supported, and I look back, while there were many good things in the Modernization Act, I think there was one part of it that was very, very wrong, and I regret deeply my own going along with it, although I had grave reservations about it, and that is the question of credit default swaps and derivatives and whether or not they are regulated. You and others told us, don't worry, these are very sophisticated players and there will be a self-regulation because they are better able to monitor those markets than we are.

Well, the more I have looked into it, the more convinced I have become that this is one of the great Ponzi schemes of all time. We think about Madoff's Ponzi scheme. That is a \$50 billion Ponzi scheme. I think derivatives, while probably the vast majority of it is completely legitimate, the part that was not was the assessment of risk, the assessment of risk.

Last year, I was with a man who was head of all derivatives trading for one of the major global financial firms and I said to him, have you ever looked at the formulas these PhDs in math have come up with to determine risk in these contracts? He said, "Yes." I said, could you understand it? He said, "No." I said, I will tell you—and this is the guy who was in charge of all derivatives trading. I said, I have got a master's in business. I asked my staff to bring me one of these formulas. I couldn't make head nor tails out of it. And it turns out they didn't have in these risk formulas any assessment of housing prices going down.

Well, to make a long story short, all of us who participated in supporting that bear responsibility. There are many other elements, the fiscal policy, monetary policy, other deregulation that was done. But you, too, have responsibility, because, you know, at least for some small part of that, you gave us bum advice.

What can you say that would make us comfortable, if we have that view, and maybe you have got a different view and I certainly respect that, especially in the presence of your daughters, who are very patient—what would you say to us who are now deeply concerned about the mistakes that were made? What would you say to assure us that you would be part of the solution?

Mr. GENSLER. Senator Conrad, I appreciate the question. Looking back now, it is clear to me that those of us involved at the time should have done more to protect the American public through strong, comprehensive, and aggressive regulation. There are some things that we raised and looking back now should have fought harder for, to regulate the actual institutions, the derivative dealers, to keep oil and metals consistently regulated with wheat and corn and other products. We should have fought—we did rec-

commend that, but in the final bill were unable to achieve either of those. We should have fought harder.

I think there were also things that were but dots on the landscape. You raised credit default swaps at the time of that legislation. Approximately 97 percent of the market were interest rate derivatives and currency derivatives, and the bulk of the remaining 3 percent was actually equity derivatives and commodity derivatives, as small as they were back then. And that market has burgeoned since then.

Senator CONRAD. Exploded.

Mr. GENSLER. And in very consequential ways, where an AIG had a hook of business so significant, and I believe that those credit default swaps at AIG were often being misused, and sometimes by regulated institutions, banks in Europe that were getting protection and lowering their capital charges with regard to that.

I think also, Senator, and you raised this in your question, I think there was an assumption at the time about whether the regulation of institutions, these large financial institutions, would be enough. And I do think in retrospect that assumption was thoroughly tested for a couple of reasons.

One, even where there was broad regulation, at the holding company and of everything, there was no specific regulation of the derivatives affiliate. I believe that even now, where the Federal Reserve might have broad holding company regulation, that if confirmed, I would look forward to working with Congress and the other regulators to make sure that the dealers themselves have to have capital, business conduct, and reporting requirements. But capital is the shock absorber, so to speak, to guard against excess leverage. I have come firmly to believe that.

At the same time, I believe that we need to have a full regulatory regime for the market so that the centralized clearing, and we could get the benefits of centralized clearing as we have in the futures market, and those benefits might sound like back-office plumbing, but they are very real because just as in the futures markets, you have to post margin on a regular basis and have a sort of a daily reckoning of these contracts and at the same time have to send in the information and have all the positions and the recordkeeping and reporting.

Exchanges bring transparency to transactions. Where small businesses, small commercial interests right now, I believe, actually pay more for even the standardized products, more because they don't have that transparency. Now, just one basis point might be a little bit, but transparency to an overall market, I think, brings further economic prosperity, as well.

So I do think, looking back now, it is clear to me we should have done more. But over time, I believe that some of these weaknesses have been sorely tested. The regulatory and financial system completely failed the American public in this regard. And I look forward, if confirmed, working with you, as I did with Senator Sarbanes, to try to sort of sort through some of that complexity, the dust that might be kicked up by opponents, and they will be very strong and loud opponents, some of them raising legitimate concerns, but trying to find how we can best protect the American pub-

lic and bring a regulatory regime to a field that hasn't had one to this date.

Senator CONRAD. Well, I appreciate that answer. You know, I look back. I have been trying to write an analysis of what has happened here, a broader look at all the factors that contributed, and I do very much believe that it is a very unusual combination of a loose monetary policy, after 9/11 we had very low interest rates for a very extended period of time, a very loose fiscal policy with massive Federal deficits.

At the time when the economy was strong, we still had a very loose fiscal policy, very unusual to have loose monetary policy and loose fiscal policy simultaneously, coupled with very loose trade policy with record trade deficits. And then the deregulation that occurred and, you know, I will stand up and I will be held accountable. I made a mistake.

I mean, I will assert there were many good things in that Financial Modernization Act, but I believe there was an Achilles heel that some of us were worried about at the time but we thought the good things would overcome that weakness. Well, we were wrong and we were wrong big time and all of us need to fess up about mistakes that have been made here. We have got to try to get this back on track.

I thank the Chairman for your patience.

Mr. GENSLER. Senator, I thank you for that. I agree with your assessment, if I could, Mr. Chairman, that there was a great many things that were imbalances, and you named those, but also the regulation, that if confirmed, I would look forward to working with you and this Congress that we really do bring a full regulatory regime not only to the institutions, which I think we need to do, but also, as the Chairman has laid out in his bill, with the goal to bring it to the markets, as well.

Senator CONRAD. Thank you, Mr. Gensler. Thank you for your very honest answers.

Mr. GENSLER. Thank you.

Chairman HARKIN. Thank you, Senator Conrad.

Well, Mr. Gensler, this has been a great hearing. I think we have gotten great responses and an open and frank discussion. I don't mean to belabor it any longer, although in listening to just the last two questioners here, Senator Chambliss and Senator Conrad, I was just jotting down here CMS, CVOs, CMOs, CMBSs that is commercial mortgage-backed securities—CDSs. Now we have gotten into things like CDO-squared, CDO-cubed, and you just keep slicing these tranches of derivatives out there all the time.

The financial sector has come up with all of these exotic products. No one really understands them except maybe a few people on Wall Street, and they may not fully. But credit default swaps didn't exist before about 1998, not really.

Mr. GENSLER. That is right, sir.

Chairman HARKIN. And the world seemed to operate just fine without them. The same with collateralized debt obligations or collateralized mortgage obligations. All this creativity in new contracts happened in the early 1980's, through the late 1980's, and then they really boomed in the 1990's, all these different derivative contracts and financial products.

I asked the question in our October hearing, I said, what market forces out there demanded these products? Who was demanding this? The answer came, no one. It is just that a few of the financial institutions had some of these whiz kids and mathematical geniuses. Now they have big computers that could slice and dice these obligations into all these little tranches, securitize them as bonds, and then sell tranches, a highly leveraged tranche, or one that is not so highly leveraged, and on and on until finally you get this morass out there of instruments that no one really understands.

I asked Secretary Paulson one time when we had one of our meetings last fall, before the TARP. I said, why don't we insist, if we are going to put this money out, we insist that each one of those entities receiving this federal money give us a valuation of each one of those instruments that they have and insist on what is the value. His response, and we were all in that room together, his response was, "Well, they don't even know what the value is." Billions of dollars, and they have no idea what the value is.

Well, I don't know. I just think we have to—and this is not really in your bailiwick, but I just think we in the Congress have to really think about whether or not all these financial products and instruments are worthy of legitimacy. And they are all off exchanges. These aren't on exchanges. We have no idea what is going on out there. So I don't know if they are legitimate or not. I tend to think in some of these cases they are probably not, especially when you get into synthetic derivatives or you get into the naked credit default swaps. It boggles the mind about what people are doing with these instruments.

Now, it would be all right if these investment bankers were using their own money to do that. I could care less. But they are using my money, your money, my constituents' money that is in 401(k)s, pension plans, all other kinds of devices where they have taken money now and are investing it in these and so they are playing with our money.

So I just raise the question, I guess, on markets. We all believe in the market, but as you pointed out, I think for a market to really function, you have to have three things. Correct me if I am wrong. You have an MBA; I don't.

[Laughter.]

Mr. GENSLER. But an MBA, sir, doesn't mean—with all respect, it doesn't mean that you have—

Chairman HARKIN. I am just kidding you. My daughter has one. I keep asking her this. But it seems for a market to function, you have to have many buyers, many sellers, and transparency. If you mess up one of those, you don't really have a market. You may call it a market. Many buyers, many sellers, transparency. Once you have few buyers, many sellers, or you have buyers and sellers and you don't have transparency, you don't have a market.

And so when we talk about markets, we have to keep in mind just what we are talking about. What kind of markets do we want? Very few real markets exist any longer out there.

Mr. GENSLER. Mr. Chairman, I would—I know that you mean this, but I would add something else to what is a component of markets. We need regulation. We need regulated markets and so

that is what I am here to say, and if confirmed, I would look forward to working with you. Senator Conrad had asked me about what I had done in the past, and, I mean, I even wrote a book called *The Great Mutual Fund Trap*, and it wasn't by mistake that on the cover of the book it has that old three monte game. I mean, I just brought it here just because I remember it. But there is a reason that the book has that here.

Chairman HARKIN. I have got to read that.

Mr. GENSLER. Well, we will give it—it is all right if you don't read it. I am just saying there is a reason that is there.

Chairman HARKIN. But what I say about sellers, buyers, and transparency, that is what is called the, quote, "unfettered free market." Now, you are right. Do we want an unfettered free market? Do we want the free flow of capital? I hear that all the time. I read that we want the free flow of capital. Well, an economist who was at our hearing in October said, I am not certain we want the free flow of capital. We want the efficient flow of capital.

And he used an analogy which struck home with me. He said, well, it is like traffic. If you want the free flow of traffic, get rid of all your stop signs. Get rid of the stoplights. Get rid of the speed limit signs. Get rid of all the warning signs. You will have the free flow of traffic, but you will have a lot of wrecks. What you want is the efficient flow of traffic.

The same is true in financial markets. You want the efficient flow. Therefore, you need the stop signs and the caution signs and the regulations so that capital is efficient, not just free.

So anyway, I just wanted to make that point, to say that I think we really have to take a look at whether all of these types of instruments are really necessary and legitimate. If they are, they ought to be regulated. That is all I am saying.

Now, this does get into your bailiwick. Every single one of those instruments, I submit, is a future. Every single one of them is some derivative and it is based on something happening or not happening in the future and therefore would come under the purview of the CFTC. I don't know if you have any comment about that, but if we are going to continue these kinds of contracts, should they not be regulated?

Mr. GENSLER. Sir, I believe that we do need regulation and many of the list, and it was a bit of an alphabet soup for the public, but many of them are actually currently even regulated around what is called asset securitizations, not by the CFTC, but by the SEC as securities. Collateralized debt obligation is actually an asset security.

And I believe that part of regulatory reform, as the President has called for and Congress and the President are going to work closely together, and if confirmed, I am eager to lend a hand there, is that I believe that we really have to look at all asset securitizations, whether they are called collateralized debt obligations, asset-backed securities, commercial mortgage-backed securities that you mentioned, or even asset-backed securities, uncollateralized debt obligations, which because there are two sets of letters there, somebody caused that squared term you called it. That whole world of asset securitization needs to be looked at.

At the same time, the American public, though, needs the benefit of capital to start moving again, to purchase their automobile, to have the student loans, to get their credit cards rolled over, and to get their mortgages, and a lot of that is done in this securitization market, particularly as banks have so constrained their market.

So we need the rules, just like you said on the road. We need that flow of capital to the American homeowner to get the student loan, to get the car loan, to get their mortgage. But at the same time, I believe, and if confirmed, I look forward to working with you on the additional regulations that are needed even in the world of asset securitizations that come under another regulator than the CFTC.

Chairman HARKIN. We need to discuss this further because I had a student loan, and I bought a car with a loan long before any of these derivatives ever existed. So what was wrong? I don't know if these derivatives are necessary for people to get car loans or student loans or mortgages or anything else.

Mr. GENSLER. It worked well in America and it worked well for you. As many things were just dots on the landscape eight or 9 years ago, this market, too, has taken off, and so I believe it is time to work together as regulators and with Congress to see what additional rules are necessary there. Again, somewhat out of the jurisdiction of the CFTC.

Chairman HARKIN. That is true, and some of what I described is not part of the CFTC's jurisdiction.

Senator CHAMBLISS. Mr. Chairman?

Chairman HARKIN. Yes?

Senator CHAMBLISS. One reason that I was kind of pursuing a line of questioning relative to what may happen with respect to off-shore trading is I think Mr. Gensler is exactly right, that we didn't envision 10 years ago what was going to happen in the marketplace. You talk about eliminating products. Shoot, there are some smart guys out there right now that are thinking about additional products.

Chairman HARKIN. That is true.

Senator CHAMBLISS. We can't even conceive what they are.

Chairman HARKIN. That is true.

Senator CHAMBLISS. But the one thing I am impressed with is that when you say that we need to think this through and we need to make sure that we regulate these in the right way, we have got to look ahead to what type of products there may be out there that get us into this same mess again 10 years, 20 years from now if we aren't careful. We are never going to be able to anticipate exactly what those products are and nobody ever thought about packing mortgages and selling them five or six times a day.

If you talk about eliminating, I think you really cause problems. But if you are talking about making sure that you regulate in the right way and you give these guys the tools and the resources, primarily, which they don't have now, then I think we will do a better service to the consumer out there.

Chairman HARKIN. Well, Mr. Gensler, thank you very much. I thought this was a very enlightening session. I appreciate your forthrightness.

We have several letters of support, and, I might add, one letter in opposition to Mr. Gensler's nomination. I ask unanimous consent that these letters be made a part of the record.

[The following information can be found on page 70 in the appendix.]

Chairman HARKIN. I ask unanimous consent that if there are materials that other Senators wish to submit for the record, that those also be included.

I will leave the record open until noon tomorrow for any additional written questions that any Senators want to submit to Mr. Gensler, and then the record will be closed at noon tomorrow.

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, if I can thank you both for your hearing and the inquiry. I also want to thank Senator Mikulski, Senator Cardin, and Senator Sarbanes on the record for their support. If confirmed, I look forward to working with you and your staffs on this very significant agenda we have forward.

Chairman HARKIN. Mr. Gensler, may I say that it is great you have had two of your daughters here. They probably think it is probably the most boring thing that has happened to them in a long time and they deserve to have a nice dinner out tonight.

[Laughter.]

Mr. GENSLER. I thank you. I think you are right about that.

Chairman HARKIN. Thank you very much. The committee will stand adjourned.

[Whereupon, at 4:56 p.m., the committee was adjourned.]

A P P E N D I X

FEBRUARY 25, 2009

Statement of Senator Thad Cochran

February 25, 2009

Mr. Chairman, thank you for holding this nomination hearing. This hearing is very timely considering the current economic situation and the ongoing review of certain financial instruments.

The role of the Commodity Futures Trading Commission (CFTC) to help protect market participants from fraud and manipulation has never been more important. As is the case with any economic downturn, consumers often times blame government agencies for their lack of oversight and enforcement. I commend the Commission's employees for their tireless work enforcing current rules and regulations. It is critical that this Committee review and move forward with this nominee and allow the CFTC to operate with a full slate of Commissioners.

As we move forward with a full review of futures markets, it is important to keep agriculture producers in mind. Unlike speculators, agriculture producers and their lending institutions depend on these markets to hedge risks. The price volatility experienced last summer brought about challenges for many agricultural market participants, and many questions about the real impact of speculators remain open.

I am pleased that the Commodity Futures Trading Commission has announced new initiatives to address the concerns which have been raised by agriculture industries.

This past year, the CFTC announced an investigation of the cotton futures market. I urge the nominee before us today to allow this investigation to move forward and at the appropriate time provide updated information to Committee Members. Price volatility in the cotton market resulted in significant losses due to increased margin calls.

In addition, I would like to briefly highlight increased funding provided through the fiscal year 2009 omnibus appropriations bill. As you may know, the bill provides an increase of over \$34 million to hire additional staff. This significant increase of funding will allow the commission to increase staff positions and improve surveillance and enforcement of the laws.

We should be careful to select well qualified Commissioners and give them the resources they need to carry out their responsibilities. I congratulate Mr. Gensler on his nomination and look forward to continuing our review of his qualifications.

Statement of Gary Genler
 Nominee for Chairman of the Commodity Futures Trading Commission
 Before the United States Senate
 Committee on Agriculture, Nutrition and Forestry
 February 25, 2008

Chairman Harkin, Ranking Member Chambliss, and members of this Committee, thank you for the opportunity to appear before you today. I am honored to be President Obama's nominee for Chairman of the Commodity Futures Trading Commission at this critical time for the commodities markets, and for our nation.

As a champion of the public's interest -- for farmers, consumers, small businesses -- the CFTC plays an essential role in our financial regulatory system and affects the lives of all Americans. I firmly believe that strong, intelligent regulation with aggressive enforcement benefits our economy and the public.

The current economic crisis clearly has shown that our financial and regulatory systems have failed the American people terribly. Those of us who have spent our professional lives around markets have to approach the current crisis with humility following these broad failures. We have learned the limits of our ability to foresee how markets may evolve, the importance for absolute candor with the public about the risks we face and the need for unceasing vigilance to address them. We have learned that there is no substitute for strong independent regulation and that transparency and accountability are essential throughout the system. We must always err on the side of protecting the American people.

Those are the lessons that I draw from what has dramatically transpired over the past decade. If confirmed by the Senate, I pledge to this committee that I will not forget these lessons.

We must now repair our regulatory system by enacting much-needed reforms that promote transparency, fairness, and safety. To be effective, these regulations must be able to adapt quickly to developing technologies, new products, and to changes in our global economy.

If confirmed, I will tackle what I believe are four essential priorities for reforming the commodities markets and the financial system:

- Strengthen Enforcement

First, the CFTC must vigorously fulfill its mandates: enforcing existing laws strongly, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation. I will work tirelessly to ensure the Commission leaves no stone unturned in ferreting out and putting a stop to activities and practices that hurt the American public. We also must work together to provide adequate funds for this agency which I believe currently lacks sufficient resources to fulfill its mission.

- Prevent Excessive Speculation

Second, I believe increased speculation in energy and agricultural products has hurt farmers and consumers. A transparent and consistent playing field for all physical commodity futures should be the foundation of our regulations. Position limits must be applied consistently to all markets and trading platforms and exemptions to them must be limited and well-defined.

- Regulate Over-the-Counter Derivatives

Third, we must urgently develop a broad regulatory regime for over-the-counter derivatives markets. Standardized derivatives should be brought into mandated centralized clearing and onto exchanges. Derivatives dealers need direct regulation, including capital, business conduct, and reporting rules. Additionally, regulations need to be developed for customized bilateral swaps while allowing commercial interests the benefit of these hedging tools. Credit default swaps, given their unique nature, also will require further regulation.

- System Wide Reform

Fourth, I believe that the CFTC must work with Congress, with other regulators, and with our global financial partners to ensure that the failures of our regulatory and financial systems, failures which have already taken a toll on every American, never happen again. Today's complex financial markets are global and irreversibly interlinked. We must ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards that we demand of our markets. This is the only way we can be sure that Americans are fully protected.

I am a proud believer in financial reform, tough regulation and enforcement. I have been privileged to have had broad exposure to financial markets, here and in Asia, in public service and on Wall Street, as an investor advocate and a government official.

My experiences have taught me the importance of having a strong working relationship with Congress. In these transformational times, we have a unique opportunity – working together --to bring bold and necessary reform to our financial market regulation. We must make the most of the opportunity to ensure that we deliver on the clear expectations Americans have set for us.

I would like to close by saying how much the support of my family and my three daughters – who will sacrifice much if I am honored with this challenge – means to me. Anna, my eldest, is a freshman in college and could not be here. Her sisters, Lee and Isabel, are with me and it gives me great pride to introduce them to you.

Thank you Mr. Chairman, Ranking Member Chambliss, and members of this Committee. I look forward to answering your questions.

DOCUMENTS SUBMITTED FOR THE RECORD

FEBRUARY 25, 2009

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used). - Gary Gensler
2. Date and place of birth. - (b)(6)
3. Marital Status (include maiden name of wife or husband's name). List spouse's occupation, employer's name and business address(es).

I am widowed, having been married to Francesca Danieli, who was an artist.

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

I graduated summa cum laude from the University of Pennsylvania's Wharton School in 1978, with a Bachelor of Science in Economics, having matriculated in September 1975. I received a Master of Business Administration from the Wharton School's graduate division in 1979, having matriculated in September 1977.

5. Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

I have had the following employment:

- a) Ernst & Whinney, staff accountant for the summer of 1978
- b) Goldman Sachs Group, 18 years from 1979 to 1997, a partner from 1988 to 1997. I joined the Mergers & Acquisitions Department in 1979 and assumed responsibility for the firm's efforts in advising media companies in 1984. I subsequently joined the Fixed Income Division in the Mortgage Department and then directed Goldman's Fixed Income and Currency trading efforts in Tokyo. My last role was Co-head of Finance, responsible for worldwide Controllers and Treasury for Goldman Sachs.
- c) See question 7 for government service

I have had the following associations with for-profit enterprises:

- a) Enterprise Community Investments, Director, 2001 to 2008
- b) New Mountain Capital, Advisory Board member and investor, 2001 to present
- c) Strayer Education, Director, 2001 to present
- d) WageWorks, Director, 2006 to present

I have had the following associations with non-profit enterprises:

- a) The Baltimore Museum of Art, Trustee, 2001 to 2007
- b) The Bryn Mawr School, Trustee, 2002 to 2008
- c) East Baltimore Development, Inc., Director, 2003 to 2007
- d) Enterprise Community Partners, Trustee, 2001 to present
- e) Johns Hopkins Center for Talented Youth, Advisory Board Member, 2003 to present
- f) Maryland Democratic Party, Treasurer, 2003 & 2004
- g) The Park School of Baltimore, Trustee, 2007 to present
- h) Robert F Kennedy Center for Justice and Human Rights, Trustee, 2008 to present
- i) Tilles Foundation, Trustee, 1989 to present
- j) University of Maryland, Baltimore County, Advisory Board Member, 2002 to 2007
- k) Washington Hospital Center, Director, 2006 to present

Though not ever as an employee, I also have had associations with various family entities as I have indicated to the Office of Government Ethics and the Commodities Futures Trading Commission designated agency ethics officials.

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

None

7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

- a) US Department of Treasury, Assistant Secretary for Financial Markets. September 19, 1997 - Confirmed by the Senate by Voice Vote. Grade: PAS
- b) US Department of Treasury, Under Secretary for Domestic Finance. April 21, 1999 - Confirmed by the Senate by Voice Vote. Grade: PAS
- c) Senator Paul Sarbanes, Senior Advisor in 2002, on the legislative effort that became the Sarbanes-Oxley Act

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None

9. Political Affiliation: The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Democratic Party

10. Other Memberships: List all organizations to which you belong, excluding religious organizations.
- a) American Automobile Association
 - b) The Baltimore Museum of Art
 - c) Maryland Athletic Club
11. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or commodity futures policy or related matters.
- Books – *The Great Mutual Fund Trap* published by Random House, September 24, 2002;
 Articles – None; Columns – I wrote two columns which appeared in the Baltimore Sun, one in May, 2001 about the challenges facing the US Postal Services and the other on February 11, 2002 about the State of Maryland’s Retirement Pension system. I do not have copies of either column. Speeches – None on the enumerated issues.
12. Health: What is the present state of your health?

Excellent

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

I will upon confirmation

2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

As a participant in a Goldman Sachs defined benefit pension plan, which was frozen in 1986, I am to receive a single life annuity of \$6700 per year upon reaching age 65 in 2022.

I have a total of 11041 vested stock options in a private company, WageWorks. (208 options with a strike price at \$3.33 and 10833 options with a strike price at \$4.14) In addition, I have 26959 unvested options that will terminate upon my resignation from the board of WageWorks.

3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)

No

4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in Federal commodity price support programs? (If yes, provide all details including amounts of direct government payments and loans received or forfeited by crop and farm, etc. during the past five years.)

No

5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a direct or guaranteed loan from or cosigned a note to the Rural Business-Cooperative Service, Rural Housing Service, the Rural Utilities Service or their predecessor agencies, the Farmers Home Administration, the Rural Development Administration, the Rural Housing and Cooperative Development Service or the Rural Electrification Administration? (If yes, give details of any such loan activity during the past 5 years.)

No

6. Have you, or any partnership or closely held corporation in which you have an interest, ever received payments for crop losses from the Federal Crop Insurance program? (If yes, give details.)

No
7. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

None
8. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

None
9. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

None
10. Identify all investments, obligations, liabilities, or other relationships which involve potential conflicts of interest in the position to which you have been nominated.

In connection with the nomination process, I have consulted with the Office of Government Ethics and the Commodities Futures Trading Commission's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Commission's designated agency ethics official.
11. Have you ever received a government guaranteed student loan? If so, has it been repaid?

None
12. If confirmed, explain how you will resolve any potential conflict of interest, including any that may be disclosed by your responses to the above items.

In connection with the nomination process, I have consulted with the Office of Government Ethics and the Commodities Futures Trading Commission's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Commission's designated agency ethics official.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

January 22, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Gury Gensler, who has been nominated by President Obama for the position of Chairman, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the Commodity Futures Trading Commission concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is a letter dated January 21, 2009, from Mr. Gensler to the agency's ethics official, outlining the steps Mr. Gensler will take to avoid conflicts of interest. Unless a specific date has been agreed to, the nominee must fully comply within three months of his confirmation date with any action he agreed to take in his ethics agreement.

Based thereon, we believe that Mr. Gensler is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures

January 21, 2009

Mr. John P. Dolan
Counsel and
Alternate Designated Ethics Official
Office of the General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

This letter describes the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Chairman for the Commodity Futures Trading Commission ("CFTC").

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1) or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that the interests of the following persons are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

I was formerly employed by Goldman Sachs as a Partner and terminated my position in 1997. I am a participant in a Goldman Sachs defined benefit pension plan, which was frozen in 1986 and will receive a single life annuity of \$6700 per year upon reaching age 65 in 2022. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of Goldman Sachs to provide this contractual benefit, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Within 90 days of my confirmation, I will divest my interests in the following entities, which I hold through Annabel Lee, LLC: New Mountain Affiliated Investors, New Mountain Affiliated Investors II, New Mountain Affiliated Investors (Cayman), and New Mountain Affiliated Investors III. With regard to each of these entities, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of the entity until I have divested it, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Upon my confirmation, I will resign from my positions with the following entities: the Park School of Baltimore; the John Hopkins Center for Talented Youth; the Robert F. Kennedy Center for Justice and Human Rights; Enterprise Community Partners; Washington Hospital Center; and New Mountain Capital. For a period of one year after my resignation from each of these entities, I will not participate personally and substantially in any particular matter involving specific parties, in which that entity is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

Upon my confirmation, I will resign from my position on the board of WageWorks. Upon my resignation, I will forfeit my unvested stock options in WageWorks. Because I will continue to own both stock and vested stock options in WageWorks, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of WageWorks, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Upon my confirmation, I will resign from my positions on the board of Strayer Education. Upon my resignation and consistent with the policy of Strayer Education, Strayer Education will accelerate the vesting of my restricted stock. I will continue to hold my stock in Strayer Education. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of Strayer Education, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

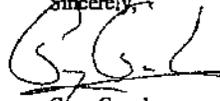
On June 30, 2008, I terminated my positions with the following entities: the Bryn Mawr School and Enterprise Community Investments. For a period of one year after my resignation from each of these entities, I will not participate personally and substantially in any particular matter involving specific parties in which that entity is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

Upon my confirmation, I will resign from my position with the Gensler Family Trust. Because I will retain a financial interest in this trust, I will comply with the requirements of 18 U.S.C. § 208(a) as to its holdings.

I have disclosed in my financial disclosure report a financial interest in the New Mountain Vantage Fund, which I hold through Annabel Lee, LLC. However, the fund's manager declined to provide me with sufficient information to enable me to disclose the fund's underlying assets in my financial disclosure report. Therefore, I will divest my financial interest in the New Mountain Vantage Fund within 90 days of my confirmation. Until I have divested New

Mountain Vantage Fund, I will not participate personally and substantially in any particular matter in which to my knowledge I have a financial interest, if the particular matter has a direct and predictable effect on the financial interests of New Mountain Vantage Fund, or its underlying assets, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Sincerely,



Gary Gensler

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | |
|--|---|--|--|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate box) <input type="checkbox"/> Incumbent <input checked="" type="checkbox"/> New Entrant, Nominee or Candidate <input type="checkbox"/> Termination Filer | Calendar Year Covered by Report <input checked="" type="checkbox"/> X <input type="checkbox"/> Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting Individual's Name Last Name: _____ Gender: _____ Title of Position: _____ Chairman: _____ | (First) Name and Middle Initial: _____ Gary Department or Agency (If Applicable): _____ Commodity Futures Trading Commission | Address (Number, Street, City, State, and ZIP Code): _____ Telephone No. (include area code): _____ | Reporting Periods Incumbents: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) (b)(6) | Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) None | Title of Position(s) and Dept(s) Held None | Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Presidential Nominee Subject to Senate Confirmation | Name of Congressional Committee Considering Nomination Committee on Agriculture, Nutrition and Forestry | Do You Intend to Create a Qualified Domestic Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | Nominee, New Entrants and Candidates for President and Vice President: Schedule A—The reporting period for nominees (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. Schedule B—Not applicable. Schedule C, Part I (Liabilities)—The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. Schedule C, Part II (Agreements or Arrangements)—Show any agreements or arrangements as of the date of filing. Schedule D—The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| Certification I CERTIFY that the statements I have made on this form and all attached schedules are true, accurate and correct to the best of my knowledge. | Signature of Reporting Individual [Signature] | Date (Month, Day, Year) January 21, 2009 | Assistant Vice Chair: _____ DCP Use Only: JAN 21 2009 |
| Other Review (If desired by agency) | Signature of Other Reviewer [Signature] | Date (Month, Day, Year) 01-21-2009 | |
| Agency Ethics Official's Opinion On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below). | Signature of Designated Agency Ethics Official/Reviewing Official [Signature] | Date (Month, Day, Year) 1.21.09 | |
| Office of Government Ethics Use Only | Signature [Signature] | Date (Month, Day, Year) 1/23/09 | |
| Comments of Reviewing Officials (if additional space is required, see the reverse side of this sheet) (Check box if filing extension granted & indicate number of days _____) <input type="checkbox"/> | | | |
| (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | |

02

Reporting Individual's Name

Grey Censor

SCHEDULE A continued

Page Number
Page 3 of 15

(Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | |
|--|---|---|---|---|---|---|---|---|---|----|--|----------|---|--|---------------------------|--|--|--|
| | BLOCK B | | | | | | | | | | Type | Amount | | | | | | |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Dividends | Interest | | | None (or less than \$201) | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | |
| 1 Union Hospital Municipal Bond | | | | | | | | | | | | | | | | | | |
| 2 Johns Hopkins Hospital Municipal Bond | | | | | | | | | | | | | | | | | | |
| 3 BWI Airport Municipal Bond | | | | | | | | | | | | | | | | | | |
| 4 IRA - Vanguard European Stock Index Fund | | | | | | | | | | | | | | | | | | |
| 5 IRA - Vanguard Total Stock Market Index Fund | | | | | | | | | | | | | | | | | | |
| 6 IRA - Vanguard Emerging Market Stock Index Fund | | | | | | | | | | | | | | | | | | |
| 7 Genstar Family Trust - Vanguard Tax Exempt Money Market Fund | | | | | | | | | | | | | | | | | | |
| 8 Genstar Family Trust - Vanguard Emerging Markets ETF | | | | | | | | | | | | | | | | | | |
| 9 Genstar Family Trust - Vanguard European Stock ETF | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name
 Gary Gensler

SCHEDULE A continued
 (Use only if needed)

Page Number
 Page 4 of 15

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | |
|--|---|--|--|--|--|--|--|--|---|----------|---------------------------|--|----------------------|--|------------------------|--|-------------------------|--|---|--|---------------|--|
| | | | | | | | | | Type | | Amount | | | | | | | | | | | |
| | | | | | | | | | Dividends | Interest | None (or less than \$201) | | Over \$201 - \$1,000 | | Over \$1,000 - \$5,000 | | Over \$5,000 - \$25,000 | | | | Over \$25,000 | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | |
| 1 General Family Trust - T Rowe Price Global Stock Fund | | | | | | | | | | | | | | | | | | | | | | |
| 2 Francesca Daniel Revocable Trust - Vanguard Tax Exempt Money Market Fund | | | | | | | | | | | | | | | | | | | | | | |
| 3 Francesca Daniel Revocable Trust - Vanguard European Stock Index Fund | | | | | | | | | | | | | | | | | | | | | | |
| 4 Francesca Daniel Revocable Trust - Strayer Education Common Stock | | | | | | | | | | | | | | | | | | | | | | |
| 5 Francesca Daniel Revocable Trust - Vanguard Total Stock Market Index ETF | | | | | | | | | | | | | | | | | | | | | | |
| 6 Annabel Lee, LLC - Vanguard Tax Exempt Money Market Fund | | | | | | | | | | | | | | | | | | | | | | |
| 7 Annabel Lee, LLC - Vanguard 500 Index Fund | | | | | | | | | | | | | | | | | | | | | | |
| 8 Annabel Lee, LLC - Vanguard European Stock Index Fund | | | | | | | | | | | | | | | | | | | | | | |
| 9 Annabel Lee, LLC - iShares MSCI EAFE ETF | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Print Editions Cannot be Used.

Reporting Individual's Name
 Gary Gensler

SCHEDULE A continued

Page Number
 Page 5 of 15

(Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | | | | | |
|---|---|--------------------|---------------------|----------------------|-----------------------|-------------------------|------------------|--|----------|----------|---------------------------|------------------|----------------|----------------|------------------|------------------|--|--|--|--|----------|--|--|
| | None <input type="checkbox"/> | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 | Type | Amount | | | | | | | | | | Other Income (Specify Type & Amount) Amount | Date (Mo., Day, Yr.) Only if Recurring | | | |
| | | | | | | | | | Dividend | Interest | None (or less than \$201) | 60-72% - 100% IS | Over \$100,000 | Over \$500,000 | Over \$1,000,000 | Over \$5,000,000 | | | | | | | |
| 1 Annabel Lee, LLC - Vanguard Emerging Markets ETF J | | | | X | | | | | | | | | | | | | | | | | | | |
| 2 Annabel Lee, LLC - Vanguard European Stock ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 3 Annabel Lee, LLC - Vanguard Small Cap Index ETF J | | | | X | | | | | | | | | | | | | | | | | | | |
| 4 Annabel Lee, LLC - Vanguard Total Stock Market ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Annabel Lee, LLC - New Mountain Affiliated Investors: 3 Underlying Assets Listed Below J | | | | | | | | X | X | | | | | | | | | | | | \$10,800 | | |
| 6 Appia Inc. (Government Technology) Contracting 46% of capital J | | | | | | | | | | | | | | | | | | | | | | | |
| 7 Overland Solutions (Outsourced Insurance Services) 48% of capital J | | | | | | | | | | | | | | | | | | | | | | | |
| 8 SXC Health Solutions 7% of capital J | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued (Use only if needed) | | | | | | | | | | Page Number Page 7 of 15 | | | | | | | | |
|--|---|--|----------------------|-----------------------|-----------------------|-------------------|----------------------------|-------------------|-----------------|---------------|---|-----------------------------|---|---|-------------------|--------------------|---------------------|---------------|----------------|----------------|
| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead | | | | | | |
| | | | | | | | | | | | Type | Amount | | | | | | | | |
| | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$1,000,000* | \$5,000,001 - \$10,000,000 | Over \$10,000,000 | Excluded Trusts | Excluded IRAs | Dividends | Interest | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | Over \$25,000 | Over \$100,000 | Over \$500,000 |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | |
| 1 Annabel Lee, LLC - New Mountain Affiliated Investors (Cayman) - 2 Underlying Assets Listed Below | | | | | | | | | | X | | | | | | | | | | \$14,700 |
| 2 Paris Re Holdings Limited | | | | | | | | | | X | | | | | | | | | | |
| 19% of capital | | | | | | | | | | | | | | | | | | | | |
| 3 Valctus Holdings, Ltd. | | | | | | | | | | X | | | | | | | | | | |
| 81% of capital | | | | | | | | | | | | | | | | | | | | |
| 4 Annabel Lee, LLC - New Mountain Affiliated Investors III - 3 Underlying Holdings Listed Below | | | | | | | | | | X | X | X | | | | | | | | |
| 5 Maritime Holdings (Delaware), LLC (Ocean Transport & Logistics) | | | | | | | | | | | | | | | | | | | | |
| 31% of capital | | | | | | | | | | | | | | | | | | | | |
| 6 Oakleaf Global Holdings, Inc. (Facilities Management) | | | | | | | | | | | | | | | | | | | | |
| 48% of capital | | | | | | | | | | | | | | | | | | | | |
| 7 Tygha Commercial Finance Group (Commercial Finance) | | | | | | | | | | | | | | | | | | | | |
| 23% of capital | | | | | | | | | | | | | | | | | | | | |
| 9 Annabel Lee, LLC - New Mountain Venture - Underlying Holdings Not Disclosed; Fund Manager does | | | | | | | | | | | | | X | | | | | | | |
| 8 Not Revealed to Investors | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.
 Prior Editions Cannot Be Used.

Reporting Individual's Name
 Gary Gensler

SCHEDULE A continued
 (Use only if needed)

Page Number
 Page 9 of 16

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$101)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | | |
|------------------------------|---|--|--|--|--|--|-------------------------------|---|---------------------|----------------------|------------------|--------------------|---------------------|----------------------|---|---------------------------|--------------------|---------------------|----------------------|-----------------------|------------------|
| | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | Type | Amount | | | | | | Other Income (Specify Type & Actual Amount) | Only if Irregular | | | | | |
| | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 * | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | None (or less than \$101) | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$5,000,000 |
| 1 | | | | | | | | | | | | | | | | | | | | Board Fees \$80600 | |
| 2 | | | | | | | | | | | | | | | | | | | | Board Fees 36500 | |
| 3 | | | | | | | | | | | | | | | | | | | | Board Fees 70000 | |
| 4 | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is joint that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

63

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | |
|--|---|--|--|--|--|--|--|--|--|--|---|--------|--|--|--|--|--|--|--|--|---|---|
| | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | Type | Amount | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Historical |
| | | | | | | | | | | | | | | | | | | | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | |
| 1 DC1 Beta Trust - Vanguard Tax Exempt Money Market Fund | A | | | | | | | | | | | | | | | | | | | | | |
| 2 DC1 Beta Trust - Vanguard Emerging Markets ETF | X | | | | | | | | | | | | | | | | | | | | | |
| 3 DC1 Beta Trust - Vanguard European Index ETF | | | | | | | | | | | | | | | | | | | | | | |
| 4 DC1 Beta Trust - Vanguard Total Stock Market Index ETF | | | | | | | | | | | | X | | | | | | | | | | |
| 5 DC2 Beta Trust - Vanguard Tax Exempt Money Market Fund | X | | | | | | | | | | | | | | | | | | | | | |
| 6 DC2 Beta Trust - Vanguard Emerging Markets ETF | X | | | | | | | | | | | | | | | | | | | | | |
| 7 DC2 Beta Trust - Vanguard European Index ETF | | | | | | | | | | | | | | | | | | | | | | |
| 8 DC2 Beta Trust - Vanguard Total Stock Market Index ETF | | | | | | | | | | | | X | | | | | | | | | | |

This category applies only if the asset/income is solely that of the filer's spouse or dependent child. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name

Gary Gensler

SCHEDULE A continued

Page Number

Page 11 of 16

(Use only if needed)

| BLOCK A | BLOCK B | | | | | | | BLOCK C | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | |
|--|--|------|------------------|----------------|----------------|----------------|---------------|---------|----------|----------|--------------------------|------------------|----------------|----------------|---|--|----------------|
| | Valuation of Assets at close of reporting period | None | Over \$1,000,000 | Over \$500,000 | Over \$250,000 | Over \$100,000 | Over \$50,000 | None | Dividend | Interest | None (or less than \$20) | Over \$1,000,000 | Over \$500,000 | Over \$250,000 | | | Over \$100,000 |
| 1 DC3 Alpha Trust - Vanguard Tax Exempt Money Market Fund DC | | | | | | | | | | | | | | | | | |
| 2 DC3 Alpha Trust - Vanguard Emerging Markets ETF DC | | | | | | | | | | | | | | | | | |
| 3 DC3 Alpha Trust - Vanguard European Index ETF DC | | | | | | | | | | | | | | | | | |
| 4 DC3 Alpha Trust - Vanguard Total Stock Market ETF DC | | | | | | | | | | | | | | | | | |
| 5 DC1 - Israel Bond DC | | | | | | | | | | | | | | | | | |
| 6 DC2 - Israel Bond DC | | | | | | | | | | | | | | | | | |
| 7 DC3 - Israel Bond DC | | | | | | | | | | | | | | | | | |
| 8 Bank of America Checking Account DC | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name: **Gary Genster** Page Number: **Page 13 of 15**

SCHEDULE C

Part I: Liabilities
 Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your personal residence unless it is rental out; loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

| None <input checked="" type="checkbox"/> | Category of Amount or Value (\$) | | | | | | | | | |
|--|----------------------------------|------------------|-------------------|-------------------|---------------------|-----------------------|-----------------------|------------------------|-----------------|------|
| | \$10,001 - 50,000 | 50,001 - 100,000 | 100,001 - 250,000 | 250,001 - 500,000 | 500,001 - 1,000,000 | 1,000,001 - 2,500,000 | 2,500,001 - 5,000,000 | 5,000,001 - 10,000,000 | Over 10,000,000 | None |
| Examples: | | | | | | | | | | |
| 1 | | | | | | | | | | |
| 2 | | | | | | | | | | |
| 3 | | | | | | | | | | |
| 4 | | | | | | | | | | |
| 5 | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements
 Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves of absence; and (4) future employment. See instructions regarding the reporting of exemptions for any of these arrangements or benefits.

| None <input type="checkbox"/> | Status and Terms of any Agreement or Arrangement | | Party | Date |
|-------------------------------|--|---|-------------------|------------------------------------|
| | Example: | Partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/00. | | Doc Jones & Smith, Hometown, State |
| 1 | I had been fully vested under a Goldman Sachs Pension Plan, a defined benefit pension plan. My accrued benefit payable as a single life annuity at age 65 starting in 2022 is approximately \$6700 per year. | | Goldman Sachs | 11/86 |
| 2 | Upon resignation and consistent with its policy, Strayer Education will accelerate the vesting of my restricted stock. | | Strayer Education | 1/09 |
| 3 | | | | |
| 4 | | | | |
| 5 | | | | |
| 6 | | | | |

Prior Editions Cannot Be Used

67

71 of 122

| | | |
|---|-------------------|------------------------------|
| Reporting Individual's Name Gary Genster | SCHEDULE D | Page Number Page 14 of 15 |
|---|-------------------|------------------------------|

Part I: Positions Held Outside U.S. Government

Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or

consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|--|----------------------|---------------|-----------------|---------------|
| Examples: | Natl. Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6/92 | Present |
| | Doc Jones & Smith, Hometown, State | Law firm | Partner | 7/83 | 1/00 |
| 1 | See Attachment | | | | |
| 2 | | | | | |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source

Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any

corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate

None

| | Source (Name and Address) | Brief Description of Dates |
|-----------|---|---|
| Examples: | Doc Jones & Smith, Hometown, State | Legal services |
| | Moore University (client of Doc Jones & Smith), Moseystown, State | Legal services in connection with university construction |
| 1 | New Mountain Capital | Advisory Board Service |
| 2 | Strayer Education | Board Service |
| 3 | WageWorks | Board Service |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used.

SF 278
Schedule D Part 1
Positions Held Outside US Government

- a. Annabel Lee, LLC; Family Investment Company, Managing Member, 2005 to present
- b. The Baltimore Museum of Art; Non-Profit Museum, Trustee, 2001 to 2007
- c. The Bryn Mawr School; Non-Profit Education, Trustee, 2002 to 2008
- d. East Baltimore Development, Inc.; Non-Profit Community Development Organization, Director, 2003 to 2007
- e. Enterprise Community Investments; For-Profit Community Development Organization, Director, 2001 to 2008
- f. Enterprise Community Partners; Non-Profit Community Development Organization, Trustee, 2001 to present
- g. Francesca Danieli Revocable Trust; Deceased Spouse's Testamentary Trust, Trustee, 2005 to present
- h. Gensler Family Trust; Irrevocable Family Trust, Trustee, 2006 to present
- i. Johns Hopkins Center for Talented Youth; Non-Profit Education, Advisory Board Member, 2003 to present
- j. New Mountain Capital; For-Profit Private Equity Firm, Advisory Board Member and investor, 2001 to present
- k. The Park School of Baltimore; Non-Profit Education, Trustee, 2007 to present
- l. Robert F Kennedy Center for Justice and Human Rights; Non-Profit Foundation, Trustee, 2008 to present
- m. Strayer Education; For-Profit, Director, 2001 to present
- n. Tilles Foundation; Charitable Foundation, Trustee, 1989 to present
- o. WageWorks; For-Profit, Director, 2006 to present
- p. Washington Hospital Center; Non-Profit Health, Director, 2006 to present



February 20, 2009

The Honorable Tom Harkin
 Chairman, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

The Honorable Saxby Chambliss
 Ranking Member, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

The Petroleum Marketers Association of America (PMAA) would like to express support for the nomination of Mr. Gary Gensler to serve as Chairman of the U.S. Commodity Futures Trading Commission (CFTC).

PMAA is a leading national trade association in the petroleum industry representing 8,000 independent petroleum marketing companies. It is organized as a national federation of 47 state and regional trade associations who represent wholesalers and retailers of gasoline, diesel, heating oil, lubricants and renewable fuels. PMAA companies own 60,000 retail fuel outlets such as gas stations, convenience stores and truck stops. Additionally, these companies supply motor fuels to 40,000 independently owned retail outlets and heating oil to 7 million homes and businesses.

Over the last few years, futures markets have become disconnected from supply and demand fundamentals of the physical commodities. PMAA has communicated about this issue for three years and has testified before Congress on multiple occasions.

After a productive dialogue with Mr. Gensler, PMAA is convinced that he shares our commitment of reforming futures markets by imposing aggregate speculative position limits on energy futures across all contract markets at the control entity level, to prevent excessive speculation and manipulation; closing all loopholes in current law including the "swaps loophole" and the "London loophole;" encouraging mandated clearing of most over-the-counter products; reviewing all bona fide hedge exemptions; and finally, increasing staff levels and resources at the CFTC.

PMAA strongly supports the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of law and accountability. Reliable futures markets are crucial to the entire petroleum industry and the American economy.

We appreciate your consideration, and we hope that you and your Senate colleagues will act swiftly to confirm Mr. Gensler to serve as Chairman of the U.S. CFTC.

Sincerely,

A handwritten signature in black ink, appearing to read 'Dan Gilligan', written in a cursive style.

Dan Gilligan
 PMAA President

Petroleum Marketers Association of America, 1901 North Ft. Myer Drive - Suite 500 Arlington VA, 22209
 Tel: (703) 351-8000 info@pmaa.org



U.S. Commodity Futures Trading Commission
 Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581
www.cftc.gov

Michael V. Dunn
 Acting Chairman

(202) 418-5070
 (202) 418-5072 Facsimile
mdunn@cftc.gov

February 23, 2009

The Honorable Tom Harkin
 Chairman, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

The Honorable Saxby Chambliss
 Ranking Member, Committee on
 Agriculture, Nutrition and Forestry
 United States Senate
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

I am pleased to write to you in support of the nomination of Gary Gensler to serve as Chairman of the Commodity Futures Trading Commission.

Since his nomination, I have met Mr. Gensler on several occasions. Mr. Gensler, in my opinion, has done an outstanding job of studying the issues and concerns that the Commission currently faces. Not only does he have a good understanding of the issues, he has indicated that he is ready to set a course of action that will enhance the ability of the Commission to address these issues.

Futures industry participants, consumers and Congress have called for the CFTC to provide greater transparency, accountability and oversight of the commodity markets. From meetings with Mr. Gensler and reviewing his recent communications with members of Congress, I believe that his leadership will guide the CFTC to answer these calls.

We are at a critical time in financial regulatory reform. The new Administration is making decisions on how best to craft a regulatory regime that addresses our current financial crisis. It is imperative that the CFTC be a full partner in these deliberations. This can best be accomplished by confirming President Obama's choice for permanent Chairman of the CFTC as soon as possible.

Thank you for your consideration.

Sincerely,

Michael V. Dunn
 Michael V. Dunn
 Acting Chairman,
 Commodity Futures Trading Commission

QUESTIONS AND ANSWERS

FEBRUARY 25, 2009

QUESTIONS SUBMITTED BY CHAIRMAN TOM HARKINRegulation of over-the-counter derivatives

In your written testimony you addressed the urgent need to develop a broad regulatory regime for over-the-counter derivatives, stating that, "Standardized derivatives should be brought into mandated centralized clearing and onto exchanges." Your testimony suggests that customized bilateral swaps would not necessarily need to be centrally cleared or traded on exchanges. I am concerned that if we allow commercial interests to continue to enter into bilateral swaps, and to avoid exchange trading or clearing simply through what might be minor custom features in contracts, we will allow a loophole that will seriously jeopardize our efforts to restore derivatives trading to the full scrutiny and integrity of regulated exchange trading and centralized clearing. Hence your testimony draws a distinction between standardized derivatives and customized bilateral swaps, but that begs the question how to go about distinguishing between those two categories of derivative contracts, since the terms do not have obvious, set definitions and the consequences of drawing this distinction are critical.

Without necessarily prescribing a specific proposed rule, would you please explain what in your view are relevant and appropriate considerations, criteria, and approaches which should be weighed in drawing the distinction or division between standardized derivatives contracts and truly customized, individualized swaps contracts?

United States Enrichment Corporation

I understand that when you served as Assistant Secretary of Treasury for Financial Markets, Secretary Rubin delegated to you the responsibility to supervise and approve privatization of the United States Enrichment Corporation (USEC). The sale of USEC was supposed to be conditioned on specific statutory requirements, most of which proved not to have been met as subsequent events unfolded.

First, the proceeds from privatization were supposed to at least equal the net present value of the Corporation. Although the proceeds from the sale may have met this test, when the sales proceeds of \$1.8 billion were reduced by the \$325 million expenditure to buy Russian uranium and the \$381 million cost to put the Ohio plant on cold standby, the United States lost money from this transaction.

Second, the sale was not supposed to jeopardize either the health and safety of the public or the common defense and security of the country. In fact, shortly after privatization, the price

of uranium collapsed and Russia suspended shipments of uranium to the United States. Russia's continued participation in the nonproliferation of nuclear material agreement was critical to this country's national security. The Department of Energy had to step in and purchase uranium from the Russians at above market prices to preserve the nonproliferation agreement.

Third, the sale was conditioned on a reasonable assurance that adequate enrichment capability would remain in the United States to meet the demands of the domestic electric utility industry and on the continued operations of the Department of Energy's two gaseous diffusion plants through December 31, 2004. In fact, only 25 percent of the nuclear industry's fuel requirements are met from domestic sources and USEC closed the Ohio uranium enrichment plant in 2001.

Fourth, privatization was supposed to provide for the long term viability of the enrichment corporation. The corporation has a minimal credit rating of CCC.

Fifth, privatization was supposed to protect the public interest in maintaining a reliable and economical domestic source of uranium mining, enrichment, and conversion services and industries. When USEC sold off its uranium inventory to raise cash, uranium prices collapsed leading to the closure of uranium mines, and U.S. uranium output. Conversion services and industries suffered collateral damage from the reduction in U.S. uranium production.

Please respond to each of these points to justify your recommendation in July of 1998 that Treasury approve the 1998 privatization of the United States Enrichment Corporation.

Divergence between cash and futures prices in agricultural commodities

For the past two years, the prices of the wheat futures contract on the Chicago Board of Trade have failed to converge with cash prices at the expiration of the futures contracts. It is not entirely clear why this market has not demonstrated reasonable convergence, but it suggests that the futures contract is not functioning as it should. This lack of convergence creates problems for farmers, grain elevators, grain merchants, and processors who rely on futures markets to hedge grain prices.

What would you see as the CFTC's role in taking corrective action so the situation is not prolonged further and cash basis returns to more normal levels?

Will you pledge to follow up if confirmed and devote your personal attention to this problem of lack of convergence in futures and cash prices?

Role of index funds in futures prices

Many traditional participants who use the futures markets to hedge their price and inventory risk believe that a large influx of investment capital into the futures markets contributed to artificially high futures prices.

As Chairman of the CFTC, what steps would you take to help ensure that futures markets work for the intended users and that the price discovery function is not distorted by investment capital?

Position limits

In your statement, you comment that increased speculation in energy and agricultural products has hurt farmers and consumers and that position limits must be applied consistently to all markets and trading platforms and exemptions to them must be limited and well-defined. Under current CFTC practice, swaps dealers and index funds have been allowed to claim exemptions from position limits to hedge financial risk.

Would you support position limits that apply to all traders with the only exemptions for those with a bona fide risk in the cash market for a physical commodity? If not, why not?

Senator Sherrod Brown
Question for the Record for Gary Gensler

1. The privatization of United States Enrichment Corporation (USEC) raises significant questions. USEC was sold despite the fact that most of the conditions for the sale were unmet. Today, the company continues to rely on the government. You played an integral role in the privatization. Can you explain why the sale took place despite the failure to meet the conditions of the sale?
2. The failure to fulfill promises on the conditions that attached to the sale was not the last broken promise in connection with USEC. The plant in Piketon Ohio did not remain open until 2005, contrary to the agreement, and pensioners have been denied the COLAs they were promised. All the while, the United States share of the domestic uranium market continues to dwindle.

Was the privatization a mistake? Would you go about it again knowing what you know now? What would you have done differently?

3. In your role as an Undersecretary at the Treasury Department, you worked on the 1999 report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act. Given the regulatory failures of the past two years, what part of that report would you change?
4. In your capacity as an Undersecretary at the Treasury Department, what was your involvement with the enactment of the Commodity Futures Modernization Act of 2000? Have your views changed since that time regarding the need for regulation of over-the-counter swaps and derivatives by CFTC?
5. If confirmed as Chairman of the CFTC, would you support some form of mandatory clearinghouse for all over-the-counter (OTC) derivatives? This would allow regulators to fully view all OTC transactions, unlike the opaque environment that exists presently, to determine if they are adversely affecting the market's price-discovery function.
6. In your opinion, what has been the role of excessive speculation in creating unwarranted fluctuations in commodity prices? Do you support position limits on all traded commodities, regardless of where they are executed, to eliminate excessive speculation in these markets? If you would not, why not?

**Senator Bob Casey
Questions for the Record**

Oil Speculation

There has been a lot of debate about the impact of speculation and futures contracts on the price of oil. What is your view on the excessive speculation contributing to oil prices that would not normally be supported by the market? And what do you think the role of the CFTC should be in determining and overseeing speculation that is "excessive"?

CFTC Modernization

What do you think of proposals to combine the CFTC and the Securities Exchange Commission into a combine oversight authority that will regulate derivatives contracts and credit default swaps?

Public Confidence

Government has a lot of work to do in order to rebuild confidence in our ability to oversee markets and protect the public interest. What would you do as the chairman of the CFTC to rebuild that public trust and provide oversight, transparency and accountability?

**Statement of Senator Charles E Grassley
Nomination of Gary S. Gensler
to be Chairman of the Commodity Futures Trading Commission (CFTC)
February 25, 2009**

First off, I want to congratulate you Mr. Gensler on your nomination by President Obama to the Commodity Futures Trading Commission. The nomination in and of itself is a great honor and I welcome you here to the committee.

I want to start by thanking both Walt Lukken and Michael Dunn for their service as Acting Chairmen. I know this has not been an easy position to fill recently and I want to acknowledge their willingness to serve in this capacity.

The last year of events has taken a toll on both our economy and the morale of the American people. But that doesn't mean that changes we make now can't help better the situation in the future.

The CFTC has traditionally played an under the radar role, but I think that is going to change. Just by the nature of what's happening in our markets, it's time that this agency has a higher profile role.

Clearly there is a lot of disagreement about the level of problems that derivatives and credit default swaps have caused on our financial markets. And there is going to be even more disagreement about whether regulation is necessary and if so, who should be regulating these products.

This year Congress is also going to have to decide what the appropriate role of speculators is in our commodity markets. And we are going to have to decide if we are serious about giving CFTC the resources it needs to do its job effectively.

I am anxious to hear your outlook and answers on these important topics. But, I'd also like to learn more about how you believe you can separate your many years at Goldman Sachs with what will be your new responsibilities at CFTC.

Again, welcome to the committee and congratulations on your nomination.

Questions:

- 1) Do you believe there is evidence that crude oil prices were being driven by speculators last year? If so, what do you believe is the CFTC's responsibility with regard to limiting the amount of institutional speculation?
- 2) Do you think that the CFTC has acted aggressively enough to determine the impact of institutional investors and speculators on commodity markets?
- 3) Does CFTC currently have all the tools necessary to respond to the speculation in commodities by hedge funds, investment banks and pension funds? Does Congress need to act to provide additional authority to the CFTC? If so, please provide specific recommendations for additional authority.

- 4) When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?
- 5) Do you believe that further oversight of commodities trading is needed in light of the increased pressure on margin calls and market volatility that led to local elevators and major grain trading companies not being able to offer forward contracts to producers last summer?
- 6) In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 last summer. Now it's under \$40. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/3 of the original price?
- 7) It's been reported that you actually advocated exempting derivatives and credit default swaps from regulation when you were in the Clinton Administration at Treasury. Do you still feel the same way?
- 8) What do you believe is the appropriate oversight of derivatives? Which federal agency should have oversight responsibilities of these contracts?

Senator Ben Nelson
Questions for the Record
Nomination of Gary Gensler, Chair CFTC
February 25, 2009

Questions:

- (1) Last September, CFTC issues a staff report on Commodity Swap Dealers and Index Traders. While this report was generally deficient and continued CFTC's inability or unwillingness to see problems in the market, it did contain one very valuable recommendation that I would like to ask you to follow-up on. The report recommended a review of "whether to eliminate the *bona fide* hedge exemption for Swap Dealers and replace it with a new limited risk management exemption" subject to certain conditions. Specifically, CFTC staff was instructed to develop an advanced notice of proposed rulemaking for this purpose. Do you know whether that recommendation has been followed and whether the rulemaking will be forthcoming (and when)? If it has not been followed, do you have any intention of seeing that it is?
- (2) What are your views regarding mandatory clearing on an exchange for all over-the-counter (OTC) derivatives particularly the physical commodities including energy, energy products, and agriculture?
- (3) What are your views regarding the imposition of strong position limits on all traded physical commodities – including energy and agriculture – for all speculators, regardless of where they execute their orders – OTC, on exchange, or elsewhere – to eliminate excessive speculation in these markets?

Senator Pat Roberts
 Senate Agriculture Committee
 Statement and Questions for the Record
 Nomination Hearing of Mr. Gary Gensler
 CFTC Chairman
 February 25, 2009

Mr. Gensler, first, thank you for meeting with me several weeks ago. You travel in good company with Senators Sarbanes, Mikulski and Cardin at your side. In reading through your statement and subsequent responses to questions not only from members of this committee but several of our colleagues in the Senate, I think it's fair to say you have an in depth knowledge of the trading instruments used today in the marketplace.

I don't think you'll find much disagreement that based on recent history the CFTC and our other financial regulators need improvements; be that either investments in resources or policy authority. The debate will be over how much of both.

1. It is the nature of Congress to over-react. When the marketplace is over-regulated, Congress historically loosens the ~~reigns~~ too much. When the marketplace is under-regulated, Congress pulls the reins in too tightly. I think it's obvious we are coming through a period where those reins have been too loose.

reins

However; as we move forward on legislative proposals, we will look to you and your fellow commissioners to guide us on how to pull those reins back in at an appropriate level without repeating mistakes of the past. How do you suggest we find that equilibrium between regulations that protect all market participants, producers, and the public with those that provide the flexibility necessary for commerce to grow and evolve?

2. Some of the talk around here has been whether CFTC and SEC should merge. Many of my constituents are fearful that such a merger would result in the loss of expertise in the agricultural market regulators. How do you feel about proposals for a merger?

3. Members of this committee know all too well that futures prices fluctuate. This fluctuation has encouraged our producers to become not just "sellers" of their crops but "marketers." Successfully marketing one's crop helps hedge against price fluctuations and can bring stability to an operation's bottom line. But this growing practice depends upon a sound, transparent market that is free from manipulation. As head of the CFTC, what will you do to ensure that our agriculture producers are both protected and yet able to fully utilize the benefits of the futures markets?

4. Last year, Acting CFTC Chairman Lukken and SEC Chairman Cox signed a Memorandum of Understanding to work cooperatively on outstanding issues. Do you plan to honor the process outlined in that MOU? Is there another process which would be preferable to this MOU process?

5. In your statement, you advocate for mandatory clearing of all standardized derivatives contracts. You go on to support establishing a regulatory regime for customized contracts as well but not mandated clearing. Some legislative proposals being debated today would mandate that all Over-The-Counter derivative contracts go through a centralized clearinghouse. What concerns if any do you have with this proposal for mandatory clearing of all OTC derivatives contracts?

Senator Stabenow
Questions for the Record – Gary Gensler
February 25, 2009

We have often heard that one of the problems that occurred during the run up in commodities last year was that the CFTC did not have access to enough data concerning all market participants.

- Are you concerned with over-the-counter markets, which the CFTC has limited data and oversight over? Do you believe that a window is needed into off-exchange markets?
- Along those lines would you support requiring the CFTC to adopt rules defining and classifying index and swap traders for the purpose of data reporting? If so, how would you go about doing this and in your opinion who would constitute "index traders?"

The Commodity Futures Modernization Act was passed in 2000, which among other things, restricted the ability of the CFTC and the SEC to regulate swaps, including credit default swaps which have played a role in our current crisis.

- Do you support re-regulating over-the-counter derivatives and if so what do you think is the appropriate framework for regulation?
- Do you believe that there should be a requirement to clear or to transact on exchange all derivatives--even those that are not standardized and liquid?
- How do we achieve transparency for participants and regulators but not eliminate the markets or send them overseas?

February 11, 2009

The Honorable Maria Cantwell
United States Senator
511 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Cantwell:

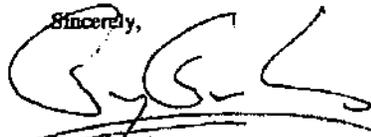
I am writing in response to your series of questions regarding my nomination to be Chairman of the Commodity Futures Trading Commission. I appreciate your meeting with me on January 15 and your leadership on the many issues facing the Commission. Please find my responses attached.

I believe the CFTC must vigorously fulfill its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation.

We also are at a transformational time that requires bold leadership to strengthen our regulatory system. The American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to repair our regulatory system and to enact far-reaching rules that promote transparency, accountability, fairness, and safety.

If confirmed by the Senate, I look forward to working with you on much needed regulatory reform. I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. Furthermore, I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace.

Should you have further questions, please do not hesitate to contact me.

Sincerely,

Gary Gensler

Please Explain your work at the Treasury Department

1. **In your capacity as an Undersecretary at the Treasury Department, you worked on the November 1999 Report of the President's Working Group on Financial Markets report on *Over-the-Counter Derivative Markets and the Commodity Exchange Act*. What specific part, if any, of this report do you disagree with today?**

We have learned a great deal in the nearly ten years since the President's Working Group on Financial Markets' report was published. Capital markets have been transformed by new financial products, the increased use of asset securitizations and 'off balance sheet' financings, the development of fully electronic markets, the significant participation of index and hedge fund investors in commodity markets, and other financial and technical innovations. We also have witnessed the harsh aftermath of Wall Street's excess leverage and risk taking, mortgage originators' weak underwriting practices, and rating agencies' shortcomings. Our financial system and our regulatory system both have failed the American people.

I believe that we must move swiftly now to apply the hard lessons we have learned. We must repair our regulatory system and enact far-reaching rules that promote transparency, accountability, fairness, and safety. To be effective regulations must adapt and stay abreast of developing technologies and new products. I firmly believe that the American public and our economy benefit from strong, intelligent regulation.

First, we must ensure that the CFTC is revitalized in order to vigorously enforce existing laws and fulfill its mandates: to promote market integrity, to prevent fraud and manipulation, and to guard against excessive speculation.

Second, we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. I believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe we must increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

Third, we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers,

formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Finally, as this crisis has powerfully demonstrated, we must work more closely with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We need to ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors that we will demand of our markets. If confirmed, I look forward to working with Congress and international regulators to achieve these goals.

- 2. As an Assistant Secretary and Under Secretary of Treasury in 1998-2001, did you oppose the regulation of over-the-counter swaps and derivatives by the CFTC? What specific actions did you take in this regard?**

During 1998, I was not involved in these matters, which occurred primarily during the spring and summer. This was during my first year at the Treasury Department and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer. The subsequent drafting and passing of the Commodity Futures Modernization Act (CFMA) legislation was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, the SEC, the CFTC and the Treasury Department. Hearings were held in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in 2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury and the Administration's positions.

- 3. In your capacity as an Undersecretary at the Treasury department, did you work to enact the Commodity Futures Modernization Act of 2000 (CFMA) which specifically exempted swaps from CFTC regulation? Did you intend to exempt credit default swaps from regulation as part of the CFMA?**

I was a member of a team that worked with and advised then-Treasury Secretary Summers on Treasury and the Administration's positions. At the time, the vast majority of over-the-counter derivative contracts were interest rate and currency swaps, constituting 97% of the market. These swaps made up 29 out of 30 derivative transactions in those days. The bulk of those remaining were equity and commodity derivatives transactions. Credit default swaps were an insignificant product at the time and not a focus during the legislative process.

- 4. Do you still support the policy to exempt swaps from regulation by the CFTC? Has your opinion changed?**

As I have previously stated, I believe we must enact a broad regulatory regime for the over-the-counter derivatives marketplace that promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

5. To what extent to you believe the enactment of the CFMA contributed to the current financial sector crisis?

I believe that both our financial system and our regulatory system failed the American people. There were many elements that contributed to these failures. To repair and reform the system, we must apply the hard lessons we have learned and tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for investors, consumers, and farmers.

I believe we must enact a broad regulatory regime for the over-the-counter derivatives marketplace. If confirmed by the Senate, I look forward to working with Congress, the Administration, and other regulators to amend the Commodities Exchange Act and create regulatory oversight for the over-the-counter derivatives market that best promotes transparency, accountability, and safety.

6. To what extent is unregulated trading in credit default swaps responsible for the current financial crisis?

I believe that many factors contributed to the current financial crisis. One of the significant lessons we have learned is that unregulated derivatives dealers, many of which were affiliates of broker dealers, threatened and in some cases destroyed their parent or affiliate, causing global shockwaves.

This was the case in AIG's failure, for example. AIG, a leading global insurance company, with many state regulated insurance subsidiaries, had an unregulated capital markets and derivatives affiliate, AIG Financial Products. This unregulated affiliate developed a significant credit default swap business. By June, 2008, they reported having a \$447 billion net notional amount of credit default swaps. Approximately two thirds of this was written to support regulatory capital of major banks, primarily in Europe. The other third was written largely in support of asset securitizations. Regulators failed to institute appropriate oversight for this unregulated dealer and others like it. Global regulators also failed to keep pace with this new and rapidly growing market, and systematically serious consequences resulted.

While serving at the Treasury Department as the Under Secretary for Domestic Finance in the late 1990's, as part of the Treasury team, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. I feel even more strongly that this is the right course of action today. If confirmed by the Senate, a high priority for me will be working with Congress and other regulators on a statutory and regulatory framework for all derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

Furthermore, if confirmed by the Senate, I look forward to working with Congress on considering further regulations for credit default swaps. This would be in addition to bringing all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establishing a statutory and regulatory framework for derivatives dealers, and formulating appropriate oversight for bilateral customized derivatives. Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps also were used by some banks to manage their bank capital requirements and to structure asset securitizations. Given these unique characteristics of credit default swaps, I believe multi-agency regulatory review and cooperation will be necessary in working with Congress to design possible new federal regulations specific to these products.

7. Do you believe all credit default swaps should be subject to mandatory clearing on a prospective basis? Or do you prefer a policy of voluntary clearing?

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing. As I have discussed above, I believe that further regulations for credit default swaps should be considered in addition to bringing all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establishing a regulatory framework for derivatives dealers, and formulating appropriate oversight for bilateral customized derivatives.

8. Should existing credit default swaps be subject to mandatory clearing?

I believe this is an important issue not only with regard to credit default swaps, but for all outstanding over-the-counter derivatives. Bringing standardized over-the-counter derivatives into mandated centralized clearing could ensure for the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Most existing over-the-counter derivatives contracts, however, were entered into on a bilateral basis. In addition, a review of publicly available data suggests that the majority of outstanding mark-to-market exposures for derivatives dealers have not been fully

collateralized. To do so would require significant additional resources and capital for the major banks.

If confirmed by the Senate, I look forward to working with Congress and other regulators to consider this important question and how to best achieve the benefits that mandated centralized clearing of existing over-the-counter derivatives could provide.

9. Which agency should Congress designate as the regulator of organizations which will clear credit default swaps: the CFTC, the Securities and Exchange Commission (SEC) or the Federal Reserve?

The CFTC has a well established record of successfully overseeing and regulating derivatives clearing organizations in the US. In my view, this experience makes the CFTC best suited for overseeing central counterparty clearing of credit default swaps.

10. Should credit default swaps be regulated as insurance? If so, should this be state based regulation or federal regulation?

Some credit default swaps have insurance-like characteristics. For example, AIG Financial Products, the unregulated affiliate of AIG discussed above, was writing credit protection for European banks and asset securitizations. This shared many characteristics with the bond insurance protection being written at the same time by monoline financial guarantee insurers like MBLA and AMBAC. Given this and other unique characteristics of credit default swaps, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new federal regulations for these products.

11. What is the social benefit from naked credit default swaps (e.g. the entity does not own the property that is covered by the swap but is simply speculating on the failure of an institution or governmental unit)? Should "naked" credit default swaps be outlawed altogether? If not, why not?

Naked credit default swaps, particularly those related to single issuers, have many attributes of a short sale of a corporate bond. Approximately half of the current credit default swap marketplace relates to single-issuer credit default swaps. Congress is currently considering legislation that would ban naked credit default swaps. If confirmed by the Senate, I look forward to working with Congress and other regulators to consider how to best protect against manipulation and market abuse that may result from trading in naked credit default swaps.

Please explain oil prices and the CFTC's regulatory response in 2008

12. What is your explanation for why oil prices increased from about \$90 per barrel in December 2007 to about \$150 per barrel in July 2008, to fall to less than \$40 today? To what extent was speculation by large banks and index investors in swaps or futures responsible for a portion of the run up?

I believe that rapid growth in commodity index funds was a contributing factor to a bubble in commodities prices that peaked in mid-2008. The expanding number of hedge funds and other investors who were increasing asset allocations to commodities within their portfolios also put upward pressure on prices.

If confirmed by the Senate, I look forward to working with Congress to take a fresh look at the role of speculation in the commodity futures markets.

13. How would you have used the regulatory tools available to the CFTC differently than the CFTC did this year to address the unprecedented spike in oil prices?

Guarding against excessive speculation and market manipulation are two core functions of the CFTC's oversight responsibility. If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current hedge exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

I believe that the CFTC could have been more vigilant in guarding against excessive speculation in the commodities futures markets. The CFTC has used no-action letters for important regulatory decisions such as allowing foreign boards of trade direct access to US customers and granting hedge exemptions. These no-action letters have had consequential effects on the Commission's regulatory programs. If confirmed by the Senate, I would undertake a thorough review of the process and standards for which matters come to the Commission and through which no-action letters are issued.

I also believe that the CFTC should promote greater transparency by providing more useful and comprehensive data to the public. For example, the CFTC currently provides weekly "Commitments of Traders" reports (COT's), which show large position interests in certain commodities subject to CFTC oversight. These published reports are segmented into "commercial" and "non-commercial" positions and in some cases, nearly 90% of reported open interests are held by non-commercial traders. I believe we could promote greater transparency and market integrity by providing a further breakdown of non-commercial open interests. If confirmed by the Senate, I will work with the CFTC staff to use the tools at our disposal to protect consumers, investors, and farmers by promoting transparency through more sophisticated data collection and dissemination.

*The Commodities Futures Modernization Act of 2000***14. Do you agree that it was prudent to provide "legal certainty" as part of the CFMA to exempt swaps from CFTC regulation?**

We have learned a great deal since that time. Capital markets have been transformed and we have witnessed the harsh aftermath of Wall Street's excesses. I firmly believe that the American public and our economy benefit from strong, intelligent regulation. To be effective, though, regulations must adapt and stay abreast of developing technologies and new products. We must move swiftly now to apply the hard lessons we have learned. We must better protect investors, consumers, and farmers by reforming our regulatory system and enacting far-reaching rules that promote transparency, accountability, fairness, and safety and ensure a crisis of this severity does not happen again.

I believe we must enact a broad regulatory regime for the over-the-counter derivatives market. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Regarding the 'legal certainty' of over the counter derivatives, this issue had been discussed since the establishment of the CFTC in 1974. Since that time, bilateral over-the-counter derivatives entered into between institutional counterparties had not been regulated by the CFTC. This was based upon a combination of the statutory language of the Commodities Exchange Act setting up the CFTC, subsequent Congressional actions, CFTC interpretations and policy statements, case law, and regulatory practice. For instance, in 1974, Congress incorporated the 'Treasury Amendment,' which exempted from CFTC regulation transactions in foreign currencies, government securities, mortgage securities, and certain other debt instruments. Later, in 1989 the CFTC Swaps Policy Statement was issued, followed in 1992 by the Futures Trading Practices Act and subsequently, in 1993, both the CFTC Swaps Exemption and Forward Contract Exemption were issued. One of the principal goals of the 2000 legislation was to provide further legal certainty under the CEA for the then existing regulatory practice.

15. Would you support a complete repeal of the CFMA?**16. If not, what specific part of the CFMA would you repeal?**Answer to 15 & 16

I believe there are many areas where the Commodities Exchange Act should be amended and improved.

In particular, I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets and enact a broad regulatory regime for the over-the-counter derivatives marketplace that promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

I also believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. If confirmed by the Senate, I look forward to working with Congress to achieve this objective.

I believe we must also reform regulation of the over-the-counter derivatives market. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Bringing all standardized over-the-counter derivatives into mandated centralized clearing could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, enhance the price discovery function, and provide additional safeguards for investors.

I believe we must establish a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps were used also by some banks to manage their bank capital requirements and to structure asset securitizations. Given these factors, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new regulations for these products.

17. What part of the economy is better off today because of the CFMA?

We are struggling through a time of unprecedented economic turmoil. The challenges cannot be overstated. I believe that both our financial system and our regulatory structure failed the American people. Many elements contributed to these failures and we have learned a great deal.

I firmly believe that the American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to reform and amend the Commodities Exchange Act to better protect investors, consumers, and farmers by reforming our regulations and enacting far-reaching rules to ensure a crisis of this severity does not happen again.

Do you support strong regulatory authority and closing ALL loopholes? Please answer the following questions yes or no.

18. Eliminating exemptions and exclusions: Eliminate the over the counter market exemptions by requiring all future transactions, including credit default swaps, to not only be subject to clearing, but to be conducted on fully regulated exchanges

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing and onto exchanges. I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Furthermore, I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

19. London Loophole: Require all Foreign Boards of Trade that solicit or accept more than a certain level of the business volume from the U.S. to register as fully regulated domestic exchanges and thus be ineligible for "no action" letters?

I support the CFTC's 2008 actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations applied to U.S. exchanges. Furthermore, I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits. If confirmed by the Senate, I look forward to working with Congress to codify the CFTC's authority to promulgate regulations

regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

20. *Enron Loophole:* Eliminate Exempt Commercial Markets as an eligible registration class and require existing Exempt Commercial Markets to register as fully regulated exchanges like a Designated Contract Market or a Designated Transaction Execution Facility?

I believe that the "Enron Loophole" should be closed and that uniform standards must be applied to contracts for physical commodities that have the same practical pricing effects, as called for in the 2008 Farm Bill. As I have stated previously, I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act.

21. *Aggregate Speculation Limits:* Set aggregate speculative position limits on energy and agriculture futures across all contract markets at the control or ownership level?

I believe the CFTC should examine ways to set aggregate speculative position limits on energy and agriculture futures across all contract markets at the control or ownership level.

22. *Manipulation Standard:* Strengthen the Commission's anti-manipulation authority from a "specific intent" burden to a "recklessness" burden bringing the CFTC more in line with the SEC, Federal Energy Regulatory commission (FERC), and the Federal Trade Commission (FTC)?

Currently, because of recent grants of anti-manipulation authority by Congress to the FERC and FTC based upon SEC case law, there is the possibility that the same set of actions in a market could be subject to different legal standards for manipulation depending upon the agency bringing the case.

If confirmed by the Senate, I look forward to working with Congress and other regulators to consider how to best utilize and interpret the CFTC's anti-manipulation authority to consistently protect consumers and enhance market integrity.

Increased Resources for the Commission

23. *User-Fee Model:* Adopt a futures transaction-fee model, that FERC uses and that the SEC has used since its inception, to increase available resources to the CFTC?

I believe the CFTC is significantly underfunded to simply meet its current mandates. The CFTC also lacks the necessary technology to monitor today's markets effectively. Likewise, I am concerned that the CFTC has not directed enough resources towards developing a robust staff of independent economists, whose work is essential to the Commission and Congress.

Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. Over the same time, exchange trading has grown exponentially, and the issues the CFTC faces have increased in complexity. Contracts traded or cleared on US futures exchanges have gone up nearly six-fold from 2000 to 2008. Thus, the CFTC's current resources do not seem appropriate to respond to the challenges we face or the times in which we live.

If Congress acts to expand the CFTC's mission and authority to better regulate over-the-counter derivatives markets, address excessive speculation, and increase investor protection, significant additional resources will be required.

I believe the critical issue is to find adequate resources to support the important work that lies ahead for this Commission. While I have not made an independent determination about user funding, if confirmed by the Senate, I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

FERC and FTC anti-manipulation authority – please answer the following question yes or no

24. Congress specifically modeled the FERC's and FTC's anti-manipulation authority to allow the agencies to pursue manipulative activity in the futures markets that impact transactions in the cash markets. On the basis of the CEA's "exclusive jurisdiction" provision, the CFTC has resisted FERC's utilization of this authority when pursuing manipulative activity which originated in the futures markets and impacted their jurisdictional cash markets, and has strongly opposed the FTC's rulemaking that would allow it to bring actions which span the physical and financial markets. Will you support dropping this opposition to the FERC's authority in court, and work cooperatively with both the FERC and FTC on allowing them to exercise their authorities to pursue manipulative conduct which spans the physical and financial markets? If not, why not?

If confirmed by the Senate, I would make it a high priority as Chairman to ensure the CFTC works with all other agencies effectively to prevent manipulation, protect investors, and enhance integrity in the physical and financial markets. We must ensure that we use the fullest grants of authority to pursue a robust enforcement agenda. More specifically, if confirmed by the Senate, I would meet with the Chairman of the FERC and of the FTC to find the most effective way to work together in furtherance of the public interest.

Sharing Answers

25. May I share your answers with interested colleagues?

I welcome your sharing these answers with interested colleagues and look forward to making myself available for meetings for follow up discussions.

February 11, 2009

The Honorable Dianne Feinstein
United States Senator
331 Hart Senate Office Building
Washington, DC 20510

Dear Senator Feinstein:

Thank you for your congratulations on my nomination to serve as Chairman of the Commodity Futures Trading Commission. I appreciate your interest and leadership on the many issues facing the Commission. Please find attached my responses to your specific questions.

I believe the CFTC must vigorously fulfill its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation.

We also are at a transformational time that requires bold leadership to strengthen our regulatory system. The American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to repair our regulatory system and to enact far-reaching rules that promote transparency, accountability, fairness, and safety.

If confirmed by the Senate, I look forward to working with you on much needed regulatory reform. I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. Furthermore, I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace.

I look forward to sitting down with you to discuss my nomination and the important work facing the CFTC.

Sincerely,



Gary Gensler

1. Commodity Futures Modernization Act. During your tenure as Undersecretary of the Treasury, Congress drafted the Commodity Futures Modernization Act that eliminated oversight of electronic markets – the Enron Loophole – and statutorily enshrined CFTC Chairman Wendy Graham’s 1992 regulatory decision to exempt all bilateral swaps from CFTC oversight.

- **Did you support exempting energy trading on electronic markets and bilateral swaps from CFTC oversight?**

I firmly believe that the American public and our economy benefit from strong, intelligent regulation. We have learned a great deal in the nearly ten years since the President’s Working Group on Financial Markets’ Report on derivatives was published. I believe that we must now move swiftly to revise the Commodities Exchange Act (CEA) in light of many lessons learned to best promote transparency, accountability and safety.

The President’s Working Group’s 1999 Report called for swap agreements that “involve a non-financial commodity with a finite supply” to be fully regulated under the CEA without exclusions. The subsequent drafting and passing of the legislation was a lengthy process that was unable to achieve this recommendation. The legislation also did not incorporate the recommendation for enhanced regulation of derivative dealers affiliated with broker dealers.

I feel even more strongly today that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe that we must move swiftly to enact a broad regulatory regime for the over-the-counter derivatives marketplace. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

- **What role did you play in drafting this legislation, and what was your view of these exemptions at the time?**

I was not involved during 1998, when the Treasury, Federal Reserve and SEC articulated significant policy positions on these matters. This was during my first year at Treasury and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer. The subsequent drafting and passing of the Commodity Futures Modernization Act (CFMA) was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, SEC, CFTC and Treasury Department. Hearings were held in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in 2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury and the Administration’s positions.

- **President Clinton’s Working Group on Financial Markets recommended regulation of derivative and swaps dealers and called for swaps clearing. Did**

you recommend that President Clinton support the final legislation that included neither of these financial safeguards?

I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives market that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges and to establish a statutory and regulatory framework for derivatives dealers. In addition, I would work with Congress to formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

While serving as the Under Secretary for Domestic Finance, as part of the Treasury team, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. We were unable to achieve this objective working with Congress on legislation. The hard lessons of the financial crisis further highlight that regulating all derivatives dealers is the right course of action today. If confirmed by the Senate, I look forward to working with Congress and other regulators on a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules

One of the President's Working Group's recommendations nearly ten years ago was to facilitate clearing houses for over-the-counter derivatives. I feel strongly that we must now bring all standardized over-the-counter derivatives into mandated centralized clearing. I believe that this should cover all standardized products, including interest rate, currency, equity, commodities and credit default swaps. This step could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

• Do you view the Commodity Futures Modernization Act as a mistake?

I believe that both our financial system and our regulatory system failed the American people. There were many elements that contributed to these failures and we have learned a great deal since the legislation was enacted. To repair and reform the system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, investors, and farmers.

To be effective, financial regulations must adapt and stay abreast of developing technologies, products and markets. I believe that we must now move swiftly to revise the Commodities Exchange Act (CEA) in light of many lessons learned to best promote transparency, accountability and safety.

▪ **What specific sections of this legislation do you support repealing today?**

First, we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. I believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe we must increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

Second, we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

2. Swaps regulation. Much like OTC energy derivative swaps, voice-brokered credit default swaps markets operate with no market monitoring to prevent manipulation, no clearinghouse holding collateral to back transactions, and no comprehensive records of who is trading what. Do you support repealing the "swaps loopholes" in Section 2 of the Commodity Exchange Act? Would you support legislation striking subsection (d), subsection (g) and paragraphs (1) and (2) of subsection (h) of the Act?

I believe that we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

I also believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the CEA.

To achieve these goals, amending each of the referenced subsections of the CEA would be required. If confirmed, I look forward to working with Congress to achieve these objectives.

3. Enron Loophole. The 2007 Farm Bill closed the Enron Loophole by requiring electronic exchanges to actively monitor trading of significant price discovery contracts. CFTC must review electronic contracts on an ongoing basis to ensure that all

significant price discovery contracts are regulated. What will you do to ensure that CFTC's review is thorough and effective?

I believe that the "Enron Loophole" should be closed and that uniform standards must be applied to contracts for physical commodities that have the same practical pricing effects, as called for in the Farm Bill. I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act.

If confirmed by the Senate, I am committed to ensuring that the CFTC vigorously fulfills its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation. I believe a critical issue is finding adequate resources to support the important work required of this Commission. The CFTC is significantly underfunded to simply meet its current mandates, and its mandates are increasing. I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

4. Prevent systemic risk through a new clearinghouse. The President's Working Group on Financial Markets (PWG) has signed a memorandum of understanding to guide oversight of a credit default swap clearinghouse, but both the SEC and the CFTC have stated in testimony that their ability to regulate a swaps clearinghouse is limited by the Commodity Futures Modernization Act.

- **Do you support legislation requiring a credit default swap clearinghouse to be registered with CFTC as a Derivatives Clearing Organization?**

I support legislation requiring a credit default swap clearinghouse to be registered with the CFTC as a Derivatives Clearing Organization (DCO).

- **CFTC is the federal agency with the most substantial history of regulating clearing organizations. The Federal Reserve has the legal power to regulate clearing, but Congress has not specified regulatory principles under which the Federal Reserve would perform this regulation. Do you believe CFTC should be the lead agency overseeing swaps clearing?**

The CFTC has a well established record of successfully overseeing and regulating derivatives clearing organizations in the US. In my view, this experience makes the CFTC best suited for overseeing central counterparty clearing of credit default swaps.

- **If multiple regulators oversee different clearinghouses, would it be difficult to ensure that any one regulator would have a comprehensive market view?**

As this financial and economic crisis has powerfully demonstrated, regulators must work more closely together and with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We

need to ensure that our partners in regulating markets both here and around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors. Regulators must have a comprehensive market view in order to fulfill their mission. If confirmed by the Senate, I look forward to working with Congress to ensure we achieve these goals.

- **Does the current memorandum of understanding allow clearinghouses to choose their regulator based on which agency is least onerous, creating a “race to the bottom” effect?**

I believe we need to work with Congress and international regulators to ensure the highest standards of customer protection and market integrity by promoting consistent guidelines for transparency, accountability, and safety that are established and strictly enforced across all global commodities markets.

5. **Require FDIC insured banks to clear all swaps in energy and credit. A clearinghouse prevents systemic risk only if large banks use it. Even if the PWG succeeds in establishing a clearinghouse, large institutions will be able to execute uncleared trades at lower cost, exposing shareholders and the American people to counterparty default risk and our economy to systemic risk. Do you support legislation to require that FDIC guaranteed entities must clear all swaps contracts?**

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing. This would include those entered into by FDIC-guaranteed entities.

6. **Risk Based Swaps Oversight. The swaps loophole allows financial and energy bilateral over-the-counter contracts to be traded without government oversight of any kind. While bilateral swaps are private contracts of infinite variation, many have a substantive impact on the market. Acting CFTC Chairman Walter Lukken advocated using a risk-based approach to monitor selectively those swaps contracts traded in large volumes, used as a price reference, standardized, or expose the market to systemic risk. This approach was adopted in the Farm Bill provisions and in the Over-the-Counter Swaps Speculation Limit Act that I introduced in September. How do you propose to regulate bilateral swaps contracts to protect the market?**

I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Bringing all standardized over-the-counter derivatives into mandated centralized clearing could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, enhance the price discovery function, and provide additional safeguards for investors.

I believe we must establish a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps were used also by some banks to manage their bank capital requirements and to structure asset securitizations. Given these factors, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new regulations for these products.

7. **A Central, Real-Time Trading Database.** My attempts to require large trader reporting of bilateral swaps failed in 2002 and 2003. As a result, no centralized source of information about voice brokered swaps exists. According to Texas Law Professor Henry Hu, "a data clearinghouse may help provide advance notice to regulators of possible entity-specific or system-wide problems and early remediation. Should problems arise, this data clearinghouse can contribute materially to the informational predicate for proper regulatory responses to such problems."

In examples including Enron, Amaranth, and AIG, regulators failed to anticipate market failures of devastating proportion because they did not have a picture of the marketplace. A data clearinghouse would enable the regulator to anticipate problems and address them.

- **Do you support creating central database of all bilateral swaps positions in both financial and energy markets held by any large trader?**

As I have stated, I believe that all standardized over-the-counter derivatives, should be brought into mandated centralized clearing and onto exchanges. I also believe that we need to formulate appropriate oversight for bilateral customized derivatives. Registration of all derivatives clearing houses with the CFTC as DCOs, along with appropriate reporting requirements for customized bilateral swaps, could serve the goal of creating a central database of all bilateral derivatives positions in both the financial and energy markets.

- **In 2008, CFTC used its special call authority to solicit swaps positions held by institutional investors, but this dataset was incomplete. Will you use CFTC's existing special call authority to establish a central swaps database for large traders within 120 days of your confirmation?**

I believe that a broad regulatory regime is needed for over-the-counter derivatives. Moving all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, formulating appropriate oversight of customized derivatives, and regulating derivatives dealers, should provide the means to establish and maintain such a central database for large traders. The CFTC also has a special call authority to solicit information from institutional investors. If confirmed by the Senate, I look forward to working swiftly with Congress to determine the best means of establishing a central swaps database for large traders.

- 8. Position Limits. OTC bilateral swaps speculators currently may hold unlimited positions, even if they do not have exposure to the underlying commodity or debt obligation. In energy commodities, unlimited speculation allows speculative positions to drive prices instead of supply and demand, and in credit default swaps traders even speculate on the third party's demise.**

- **Do you support imposing position limits on speculators in the energy swaps market and credit default swaps markets?**

Guarding against excessive speculation and market manipulation are two core functions of the CFTC's oversight responsibility. If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current hedge exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

- **Do you support legislation that would limit speculative positions to ensure liquidity while preventing speculators from dominating the market?**

I believe that the CFTC may exercise its authority at its discretion to establish position limits over all commodity futures. If confirmed by the Senate, I will ensure that all available resources and authorities are deployed to protect investors in the commodities futures markets. If those authorities are insufficient, I will not hesitate to ask Congress for additional statutory authority to ensure liquidity and guard against excessive speculation.

- **Do you support imposing aggregate position limits on energy traders, so that position limits consider positions in functionally identical products, whether they are held in bilateral swaps, on electronic exchanges, on registered exchanges, or on foreign boards of trade?**

I believe the CFTC should examine ways to set aggregate speculative position limits on energy and agriculture futures across all contract markets. If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts.

- 9. Close the London loophole. Closing the London Loophole would prevent U.S. oil and financial derivatives from being traded on international exchanges without robust oversight. According to CFTC, U.S. oil futures traders on ICE Futures Europe exceeded U.S. speculation limits every single week from 2006 to 2008. In June, CFTC announced it would limit this offshore market speculation and require recordkeeping. But legislation is still needed to require foreign exchanges with U.S. customers to adopt the same speculation trading limits and reporting requirements that apply to United States trades – ending the regulatory race to the bottom. Will you endorse legislation to close the London loophole, which Senator Levin and I introduced in 2008?**

I support all actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations and reporting requirements that are applied to trades made on U.S. exchanges. Furthermore, I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits. If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

- 10. U.S. Leadership in an international reform effort. Electronic markets, fluid capital flows, and new financial centers in emerging markets make the balkanized financial regulatory system inadequate to meet new challenges. The United States could help restore our standing in the world by calling for and leading an effort to establish minimum international standards for market transparency, accountability, and oversight. How do you intend to pursue improved international cooperation?**

As this crisis has powerfully demonstrated, we must work more closely with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We need to ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors that we will demand of our markets. If confirmed, I look forward to working with Congress and international regulators to ensure we achieve these goals.

- 11. Improve federal regulatory structure and coordination. American financial markets are overseen by seven regulators: the Federal Reserve System, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. In light of the**

conversion by Goldman Sachs and JPMorgan Chase into bank holding companies and recent acquisitions by other major financial institutions, the jurisdiction of regulatory authority has been blurred. A forward-looking, unified oversight structure should be developed to coordinate regulatory efforts and limit future gaps in oversight. What do you believe to be the benefits of maintaining CFTC independence, and what do you believe would be the benefits of combining the CFTC with other regulators?

If confirmed by the Senate, one of my principal goals will be to help reform our regulatory system, which has failed to keep Americans out of harm's way. I have a longstanding commitment to advocating for investor protection and for progressive reforms.

To revitalize our financial system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, borrowers, and investors.

I believe accomplishing these objectives must be the primary consideration in any proposed agency reforms. The CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important tasks with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake.

January 26, 2009

The Honorable Carl Levin
United States Senator
269 Russell Office Building
Washington, DC 20510

Dear Senator Levin,

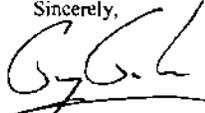
I am writing to respond to your series of questions regarding my nomination to be Chairman the Commodity Futures Trading Commission. Please find my responses attached.

I appreciated the opportunity to meet with you on January 14, 2009 to discuss the clear needs to strengthen the role of the CFTC. In addition I would like to thank you for your questions to further clarify my views on these important issues. I believe we are at a transformational time that requires bold leadership to strengthen our regulatory system.

As Chairman of the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs, I look forward to working with you should I be confirmed by the United States Senate.

Should you have further questions, please do not hesitate to contact me.

Sincerely,



Gary Gensler

**Questions for CFTC Chairman-Designee Gary Gensler
From Senator Carl Levin (D-MI)
January 26, 2009**

- 1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Can speculation in futures markets affect the actual cash price of a commodity?**

I believe that speculative trading or investing by persons who do not produce or use a commodity in order to profit from commodity price changes can affect prices for commodity futures as well as for the underlying commodities. I think we have seen this demonstrated in the commodity futures markets during the past several years.

If confirmed by the Senate, I look forward to working with Congress and my fellow CFTC Commissioners to take a fresh look at the role of speculation in commodity futures markets.

- 2. Section 4a of the Commodity Exchange Act states: "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. . . ." Section 4a directs the CFTC to establish position limits to prevent such burdens. Do you believe that excessive speculation in commodity futures traded on CFTC-regulated exchanges can cause "sudden or unreasonable fluctuations or unwarranted changes" in commodity prices?**

I believe that excessive speculation in commodity futures can cause sudden or unreasonable fluctuations or unwarranted changes in commodity prices. If confirmed by the Senate, I will ensure that the CFTC fulfills its statutory mission to guard against excessive speculation.

- 3. The CFTC has used the authority under section 4a to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. It has generally not used this authority to establish position limits to prevent levels of speculation that, absent proof of manipulation, may nonetheless significantly affect commodity prices. Do you believe that the CFTC should establish position limits to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing**

“sudden or unreasonable fluctuations or unwarranted changes” in the prices of commodities?

Guarding against excessive speculation and market manipulation are two core functions of the CFTC’s oversight responsibility. I believe that the CFTC may exercise its authority at its discretion to establish position limits over all physical commodities, including agricultural, metals and energy commodities. If confirmed by the Senate, I will ensure that all available resources and authorities are deployed to protect investors in the commodities markets.

For example, I believe there is a need to analyze all outstanding exemptions to position limits that have been granted previously to non-commercial hedgers (‘hedge exemptions’). If confirmed by the Senate, I will ask the CFTC staff to undertake a review of all outstanding hedge exemptions, to consider the appropriateness of those exemptions, and to evaluate potential practices for instituting regular review and increased reporting by exemption-holders

4. Do you believe that trading in commodity markets not regulated by the CFTC, such as over-the-counter (OTC) markets or foreign exchanges, can affect the prices of commodities in markets or exchanges regulated by the CFTC?

I believe that trading in over-the-counter derivatives markets or on foreign futures exchanges can and does affect the cash prices of commodities in the spot markets and the prices of commodity futures traded on regulated exchanges.

If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners in considering greater oversight and consistent regulation, where appropriate, for all markets relating to commodities.

5. Do you support amending the Commodity Exchange Act to provide the CFTC with sufficient authority to regulate commodity swaps and other instruments traded in OTC markets to ensure the integrity and transparency of the price of commodities traded in markets currently regulated by the CFTC?

I believe that both our financial system and our regulatory structure have failed the American people. To achieve the regulatory reform required by our citizens and the overall system, I believe we must work to ensure for a far more stable and resilient financial system, to better protect market integrity and the price discovery function, and to provide increased protection for consumers, borrowers, and investors. If confirmed by the Senate, I look forward to working with Congress, the Administration and other regulators to create a transparent, open and accountable regulatory oversight structure for the over-the-counter derivatives market.

I believe that we need to bring standardized products into mandated centralized clearinghouses and onto exchanges, establish a regulatory framework for derivatives dealers and formulate appropriate oversight for credit default swaps.

Bringing standardized derivatives products into mandated centralized clearinghouses would ensure the discipline of daily valuation of transactions through mark to market accounting. This measure would enhance the safety and soundness of the system by requiring timely posting of collateral. Clearinghouses also would give regulators a direct window into dealers' total aggregate trading positions by underlying commodities. Likewise, bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, and enhance the price discovery function.

If confirmed by the Senate, I look forward to working with Congress as well to consider appropriate regulations for customized bilateral over-the-counter derivatives.

One of the significant lessons of the financial crisis is that unregulated derivative dealers, many of which were affiliates of insurance companies or broker dealers, threatened and in some cases destroyed their parent or affiliate, causing global shockwaves. This was the case in AIG's failure, for example.

While serving at the Treasury Department as the Under Secretary for Domestic Finance in the late 1990's, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. I feel even more strongly that this is the right course of action today. If confirmed by the Senate, I look forward to working with Congress, my fellow Commissioners and other regulators to consider appropriate capital requirements, business conduct standards, and other rules for derivatives dealers.

Finally, if confirmed by the Senate, I look forward to working with Congress on considering possible further regulation of credit default swaps. Given the unique nature and close relationship of credit default swaps to corporate bonds and other securities, the CFTC, the SEC and other regulators, working in tandem, need to consider possible additional regulations to protect the integrity of the markets and investors.

6. Do you support providing the CFTC with authority to require the reporting of large trades in OTC markets in order to prevent manipulation, price distortion, or excessive speculation in CFTC-regulated futures markets?

As I stated in question 4, I believe trading and pricing in over-the-counter derivatives markets can and does have a direct effect on regulated futures markets. The initiatives I have set forth in question 5 would give the CFTC greater visibility into the over-the-counter derivatives markets if enacted. Furthermore, if confirmed by the Senate, I look forward to working with Congress to consider both the appropriateness and the potential means of extending position limits to certain of these markets.

7. The 2008 Farm Bill provided the CFTC with authority and directed the CFTC to promulgate rules to regulate commodity contracts traded on electronic trading facilities that the CFTC finds perform a significant price discovery function.

a) Do you believe that the trading of commodity contracts on electronic trading facilities like the Intercontinental Exchange (ICE) can affect the price of similar contracts traded on CFTC-regulate futures exchanges?

I believe that trading of “look-alike” contracts on electronic-trading facilities can and does affect the prices of similar contracts traded on regulated futures exchanges.

b) What priority would you place, if confirmed, on issuing the regulations called for in the Farm Bill for contracts that perform a significant price discovery function?

If confirmed, I would place a high priority on closing the “Enron Loophole” and promoting uniform standards for contracts that have the same practical pricing effects, as called for in the Farm Bill.

c) Do you agree that under the 2008 Farm Bill the CFTC has unilateral authority to determine which contracts perform a significant price discovery function and that a formal hearing or rulemaking is not required to make this determination?

The statute as enacted is clear that the CFTC has unilateral authority to determine whether an agreement, contract, or transaction performs a significant price discovery function.

8. What is your view on whether and how the growth of commodity index funds over the last 5 years has affected commodity prices?

I believe that rapid growth in commodity index funds was a contributing factor to a bubble in commodities prices that peaked in mid-2008. The expanding number of hedge funds and other investors who were increasing asset allocations to commodities within their portfolios also put upward pressure on prices. Notably, though, no reliable data about the size or effect of these two influential investor groups has been readily accessible to market participants.

If confirmed by the Senate, I look forward to working with my fellow Commissioners and the Congress to increase transparency around these commodity index funds and investors. The CFTC currently provides weekly “Commitments of Traders” reports (COT’s), which show large position interests in certain commodities subject to CFTC oversight. These published reports are segmented into “commercial” and “non-commercial” positions and in some cases, nearly 90% of reported open interests are held by non-commercial traders. I believe we could promote greater transparency and market integrity by providing a further breakdown of non-commercial open interests.

9. If confirmed, would you seek to improve the CFTC's data and public reporting of data to improve the understanding of how commodity index funds affect commodity markets? What improvements in data would you like to see?

As I have stated above in my answer to question 8, if confirmed by the Senate, I plan to reevaluate the CFTC's data collection and production capacity, particularly as it relates to the effect of commodity index funds and non-commercial traders on the broader commodities markets. The CFTC is likely to require further resources and additional technology to accomplish this goal.

10. If confirmed, how would you strengthen and improve the CFTC's market surveillance and oversight?

Providing market surveillance and oversight is one of the CFTC's core functions. As outlined in questions 5 and 6, if confirmed by the Senate, I look forward to working with Congress to address the regulation of over-the-counter derivatives and excessive speculation in commodities markets. I believe the CFTC will require increased resources to carry out these new initiatives, which will promote market integrity and increase transparency, thereby improving the surveillance and oversight functions. If confirmed by the Senate, I look forward to working with the Congress to secure the much-needed additional resources to undertake these reforms and strengthen this area.

11. What is your view of the CFTC's enforcement capabilities? How would you strengthen and improve the CFTC's enforcement capabilities and activities?

A highly functioning enforcement capability is critical to an effective CFTC. The CFTC's enforcement division has brought some notable recent actions with limited current resources. If confirmed by the Senate, I will request more attorneys and investigators to detect and prosecute fraud and manipulation in these markets and to enforce possible new regulations regarding over-the-counter derivatives and excessive speculation in the commodities markets.

12. Do you agree that the CFTC's budgetary and staff resources have not kept pace with the growth in commodity markets over the past decade? Do you agree that the CFTC is currently underfunded? If confirmed, how would you seek to improve the CFTC's budgetary and staff resources?

The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. I am also concerned that the CFTC lacks the necessary technology to monitor today's markets effectively.

If Congress acts to expand the CFTC's mission and authority to better regulate over-the-counter derivatives markets, address excessive speculation, and increase investor protection, significant additional resources will be required.

- 13. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I believe the critical issue is to find adequate resources to support the important work that lies ahead for this Commission. The CFTC is significantly underfunded to simply meet its current mandates. While I have not made an independent determination about user funding, I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

- 14. Currently, the CFTC permits certain foreign exchanges, such as ICE Futures and the Dubai Mercantile Exchange, to install trading terminals in the United States so as to permit traders located in the United States to trade various U.S. energy commodities on these foreign exchanges as well as on U.S. exchanges. In 2008, the CFTC determined that in order for ICE Futures to continue to operate its trading terminals in the United States it would require ICE Futures to impose comparable position limits to those of the NYMEX for commodities traded on both exchanges. ICE Futures and the U.K. Financial Services Authority have agreed to these conditions.**

- a) Do you support the CFTC's actions in 2008 to ensure that foreign exchanges that are operating in the United States impose position limits that are comparable to those of the U.S. exchanges that trade the same commodities?**

I support the CFTC's 2008 actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations applied to U.S. exchanges.

- b) If confirmed, would you impose similar conditions on the Dubai Mercantile Exchange and its regulatory authority, if it has not already agreed to them?**

I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits.

- c) Would you support legislation to codify the CFTC's authority to require such comparable position limits and reporting requirements in order to ensure that all foreign exchanges that seek to operate in the United States and trade U.S. commodities are subject to comparable requirements?**

If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

- d) Do you believe the CFTC currently has enforcement authority over traders in the United States who are trading on a foreign exchange through foreign terminals located in the United States if those trades affect the prices of commodities in the United States?**

I believe that the CFTC has enforcement authority over traders in the U.S. who are trading on a foreign exchange through foreign terminals located in the U.S. when and if those trades affect the prices of U.S. commodities. If confirmed by the Senate, I would work aggressively with the CFTC's legal staff to ensure that U.S. interests are protected, and I would not hesitate to come back to Congress and ask for further enforcement authorization if necessary.

- 15. It has been reported in the press that during the Clinton Administration you supported efforts to restrict the CFTC's jurisdiction over various types of swaps and other derivatives. In 2000, Congress enacted the Commodity Futures Modernization Act (CFMA) which restricted both the CFTC's and SEC's authority to regulate commodity and financial derivatives.**

- a) What were your job titles and positions from 1998-2000?**

I was Assistant Secretary of Financial Markets at the Treasury Department from September of 1997 through April 1999; thereafter through the end of the administration I was Under Secretary for Domestic Finance.

- b) Please describe your role, if any, in the efforts by the SEC, Department of Treasury, and Federal Reserve to oppose the CFTC's potential assertion of regulatory authority over swaps and derivatives in 1998.**

I was not involved in these matters, which occurred primarily during the spring and summer of 1998. This was during my first year at the Treasury Department and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer.

- c) Please describe your role during the negotiations over the CFMA, including over provisions in the CFMA to limit SEC and CFTC authority to regulate swaps, including interest rate, currency, equity, credit default, and commodity swaps. Please also include any role you played during the negotiation to limit state authority to regulate these swaps.**

The drafting and passing of the CFMA legislation was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, the SEC, the CFTC and the Treasury Department, as well as hearings in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in

2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury's positions. I do not recall participating in any negotiations over state regulatory authority.

16. In 1998, former SEC Chairman Arthur Levitt, Treasury Secretary Lawrence Summers, and Federal Reserve Chairman Alan Greenspan all opposed the CFTC's attempts to examine the OTC swaps market, and then supported the 2000 statutory restrictions on the SEC's and CFTC's authority over swaps in the CFMA. Former Chairman Levitt recently stated that he now regrets the position he took during those years: "The market was too large, too explosive in growth to merely allow pure market forces to suffice as self-regulatory mechanisms. I have some regrets about it, clearly." In October 2008, Mr. Levitt wrote: "Our nation's financial markets are in the midst of their darkest hour in 76 years. We are in this situation because of an adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions. Our regulatory system failed to adapt to important, dynamic and potentially lethal new financial instruments as the storm clouds gathered."

- a) Do you agree with former Chairman Levitt's statement that our regulatory system has failed to adapt to the development of new financial instruments and that the positions taken in 1998-2000 to deregulate these markets was, in retrospect, a mistake? If so, how would you correct this deficiency?
- b) Would you support repealing the statutory prohibitions in the CFMA on federal regulation of swaps? If so, should these swaps be regulated as commodities or securities?

Response to a) and b):

I believe that both our financial system and our regulatory structure failed the American people. There were many elements that contributed to these failures. Certainly one of these was regulators' inability to adapt to new financial instruments and technologies.

It is important now to move swiftly and intelligently to repair the system. If confirmed by the Senate, I look forward to bringing my experience in the Executive Branch, in the Legislative Branch as a senior advisor to Senator Sarbanes, in the private sector, and as an investor advocate, to help bring about far-reaching regulatory reform.

While I believe markets are central to innovation and growth, I have always advocated for sensible regulation. Well-designed financial rules with strong enforcement mechanisms are critical to protecting homeowners, investors, farmers and the integrity of our markets and economy. I believe we must create a more stable and resilient financial system, ensure market integrity by promoting transparency and accountability, and increase protection for consumers, borrowers, and investors.

As outlined in questions 5 and 6, if confirmed by the Senate, I look forward to working with Congress to address the regulation of over-the-counter derivatives and excessive

speculation in commodities markets. With respect to over-the-counter derivatives, I look forward to working to bring standardized products into mandatory centralized clearinghouses and onto exchanges, establish a regulatory framework for derivatives dealers, and consider possible further regulation for credit default swaps.

17. Former Federal Reserve Chairman Alan Greenspan testified in October that he, too, now believes that the conceptual framework underlying the deregulation of swaps in the CFMA was a mistake. Mr. Greenspan testified: "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms. . . . So the problem here is something which looked to be a very solid edifice and, indeed, a critical pillar to market competition and free markets did break down."

- a) **Do you agree with Mr. Greenspan's recent statements that the financial collapse of 2008 has demonstrated the errors in the assumptions underlying the deregulatory approach in the CFMA? Can we rely on commodity market participants and unfettered free market forces to prevent systemic risks and unreasonable price fluctuations in U.S. commodity markets?**
- b) **Do you support stronger regulation of U.S. commodity markets to protect market participants and prevent systemic risks and unreasonable price fluctuations, and, if so, how?**

Response to a) and b):

I believe that the American public and our economy benefit from a regulated market system. The recent crisis revealed that market participants have failed at their own risk management and in their obligation to protect their customers, their investors' money, their shareholders and even their franchises in many cases.

Our regulatory system also failed to protect investors, savers, borrowers, farmers and homeowners. As I mentioned in my previous answer, I believe that we must have additional safeguards in place to protect markets and investors against the risks we have witnessed in the past year. If confirmed by the Senate, I look forward to working with Congress and the Administration to meet the responsibilities that lie before us. To reform the financial system, we must establish a regulatory framework that ensures a strong and stable financial infrastructure, promotes market integrity and the price discovery function, and provides increased protection for consumers, borrowers, and investors.

As I have stated in my previous answers, I support stronger regulation of U.S. commodity markets. If confirmed by the Senate, I look forward to working to bring over-the-counter derivatives into mandatory central clearinghouses and onto exchanges, establish a regulatory structure for derivatives dealers, and consider possible additional regulation for credit default swaps.

18. What is your view of the proposal to merge the SEC and the CFTC? Would you support or oppose such a merger, prefer to retain the CFTC as a separate independent agency, or prefer some other approach?

If confirmed by the Senate, my principal goal will be to help reform our regulatory system, which failed to keep so many Americans out of harm's way. I have a longstanding commitment to advocating for investor protection and for progressive reforms. To revitalize our financial system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, borrowers, and investors.

I believe accomplishing these objectives must be the primary consideration in any proposed regulatory reforms. The CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important tasks with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake.

19. In 2004, Congress enacted legislation imposing a one-year cooling-off period before federal bank examiners could take a job with a bank they oversaw. If confirmed, would you support a similar cooling-off period for commodity regulators?

If confirmed by the Senate, I would support a similar cooling-off period for commodity regulators.



FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2010

TUESDAY, JUNE 2, 2009

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:33 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Tester, and Collins.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing on the fiscal year 2010 funding request for two key Federal regulatory agencies within the jurisdiction of this Appropriations Subcommittee on Financial Services and General Government, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

I also want to welcome my friend and my distinguished Ranking Member Senator Susan Collins. We have worked together in many venues, and I'm glad that we're going to share the responsibilities of this subcommittee.

Joining us today to present testimony on the two budgetary proposals are the Honorable Mary Schapiro, Chairman of the SEC, and the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission.

Both of these agencies enjoy unique histories, hold specialized and independent responsibilities and take different approaches to markets that serve different purposes, yet the CFTC and SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity.

We are enduring an extraordinary set of circumstances in our Nation today. We are beginning to slowly emerge from one of the greatest economic crises in decades. After years of struggle, countless families have lost their hard-earned savings, seen their dreams deferred and even denied.

Some may view the subject matter of this hearing as dry as dust, how much money to give to two Federal agencies, but if you step back for a moment and translate their work into the real world, re-

alize that their oversight and their regulation literally protects the savings and futures of American families and ensures that economies in countries around the world will view our economy and the way we run it with respect to as to whether or not the rule of law is going to be followed.

The unprecedented price volatility of our markets for fiscal commodities, such as energy and grains, has hurt our economy, in addition to the previous mention I made of some of the problems that we've had with savings and the like.

Now perhaps more than ever, we need our markets to function transparently and be insulated from manipulation and unfettered excessive speculation. Much remains to be done to stabilize and sustain our financial system.

Chairman Schapiro and Chairman Gensler each bring vast experience to their new leadership posts in this administration and have undoubtedly identified in their brief tenure ways to improve the way we approach regulating securities and futures markets.

As the subcommittee prepares to make difficult funding decisions, I look forward to hearing about the challenges their agencies will face.

In the interest of time, I am going to ask that the remainder of my statement be made a part of the record so that we will have opportunity for testimony and for questions.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

The CFTC and the SEC enjoy unique histories, hold specialized and independent responsibilities, and take different approaches to markets that serve differing purposes. Yet the CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in our country.

Market users, financial investors, and the U.S. economy rely upon vigilant oversight by these two agencies in today's evolving—and often volatile—global marketplace.

We are enduring an extraordinary set of circumstances in America today. We are beginning to slowly emerge from one of the greatest economic crises since the Great Depression. After years of sweat and struggle, countless families have lost their hard-earned savings, seeing their dreams daunted, deferred, and even denied.

When a man named Bernard Madoff can, over the span of 10 or 20 years, lure investors into what has turned out to be a Ponzi scheme, causing many of them to lose millions of dollars, and his wrongdoing goes unnoticed by major regulatory agencies, it is clear more has to be done.

When some of the major ratings agencies that gauge whether a company is doing well basically ignore their responsibility and fail to make accurate reports, everyone loses as a result of it.

The unprecedented price volatility of our markets for physical commodities, such as energy and grains, has hurt our economy. Now—perhaps more than ever—we need our markets to function transparently and insulated from manipulation and unfettered excessive speculation.

The Obama administration recently announced a comprehensive plan to significantly regulate credit default swaps and other over-the-counter derivatives. Exempting these investments from regulation has proven to be a costly mistake—contributing to the \$180 billion taxpayer bailout of AIG, the collapse of Lehman Brothers, and the demise of Bear Stearns.

This proposal will require far more transparency and responsibility from derivatives traders that have long operated in the shadows.

Things are still very fragile. Much remains to be done to stabilize, repair, and sustain our financial system on which we all depend. It will take time to redeem the lost faith of the American people in the government institutions they expected would protect them. But I believe we are moving forward with resolve toward a brighter economic course.

I appreciate the fact that Chairmen Schapiro and Gensler have each accepted President Obama's call to be part of the economic leadership team to help craft a more reliable regulatory framework and guide us to a better future.

Both Chairmen bring vast experience to their new leadership posts in this administration—and have undoubtedly identified, even in their brief tenures, ways to improve the way we approach regulating in the securities and futures markets.

As the subcommittee prepares to make difficult funding decisions for the next fiscal year, I look forward to hearing about the particular challenges their respective agencies face in today's tumultuous economic environment. I welcome their input on how we can best help to address those needs.

Before hearing from our panelists, I'd like briefly outline the missions of these agencies and their budget proposals:

Turning first to the SEC, its three-prong mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC is the investor's advocate.

The SEC is responsible for overseeing more than 12,000 publicly traded companies, over 11,300 investment, nearly 8,000 mutual funds with \$9 trillion in assets, fund complexes, 5,500 broker dealers with over 174,000 branches, 10 credit rating agencies, and close to \$44 trillion worth of trading conducted each year on America's stock and option exchanges.

The strength of the American economy and our financial markets depends on investors' confidence in the financial disclosures and statements released by publicly traded companies. Investors expect the SEC to be the vigilant "cop on the beat." Regrettably, in many respects, we let them down. I have faith in Chairman Schapiro's leadership and tenacity to turn things around.

This subcommittee wants to make certain that the SEC has the necessary resources to effectively fulfill its obligatory singular mission: protecting shareholders.

The SEC's budget request for fiscal year 2010 totals \$1.026 billion, an increase of \$8.8 million, or 8.8 percent over the agency's fiscal year 2009 enacted level of \$943 million. This proposed fiscal year 2010 budget would fund 3,692 FTE, just 40 more than the current year funding permits.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions for violations of the securities laws, such as insider trading, accounting fraud, and providing false or misleading information.

Serious, thoughtful questions have been raised about whether the proposed enforcement budget is adequate to keep pace with the growing demands.

Second, the CFTC: The CFTC is charged with protecting the public and market users from manipulation, fraud, and abusive practices. It is also responsible for promoting open, competitive, and financially sound markets for commodity futures.

The CFTC helps ensure that the futures markets are equipped to better perform their vital function in the U.S. economy—providing a mechanism for price discovery and a means of offsetting price risks.

The CFTC's oversight and enforcement mission becomes tangible when you consider that futures prices impact what we pay for the basic necessities of our daily lives: our food, clothing, shelter, fuel in our vehicles, and heat in our homes.

This year—2009—marks the 35th year since the establishment of the Commodity Futures Trading Commission. At the time of its inception in 1974, CFTC's 500 employees were tasked with the mission of ensuring fair practices and honest dealings on the commodity exchanges of America's then-\$500 billion futures industry.

Today it is a \$22 trillion industry that looks vastly different. Yes, the traditional agricultural products like wheat, corn, soybeans, and the proverbial pork bellies are still part of the picture. But the landscape has been remarkably altered and diversified with novel and complex commodities . . . everything from grains to gold, currencies to carbon credits.

In the past decade, trading volume has increased more than ten-fold—reaching well over 3.4 billion trades in 2008, and actively traded contracts have quintupled—from 286 in 1998 to 1,521 in 2008. CFTC oversees \$5 trillion of trades—daily.

Adding to this challenge is a significantly transformed globalized, electronic, and round-the-clock marketplace. Moreover, the emergence of derivatives and hedge funds have altered the regulatory environment.

Layered on this are new authorities added through the 2008 farm bill, coupled with escalating public angst about record energy and agricultural commodity price hikes and fluctuations, and a growing influx of financial funds into the futures markets.

Further complicating the picture are transactions that the CFTC currently has no power to presently regulate—the vast "shadow" world of over-the-counter derivatives—like credit default swaps.

Surprisingly, what hasn't changed is the number of staff. Despite the phenomenal surge in volume and activity, CFTC staffing levels have simply not kept pace. In fact, staffing levels have dropped by over 20 percent. CFTC's workforce—like its predecessor over three decades ago in the agency's fledgling years—presently numbers only 500.

For fiscal year 2010, the President's budget request funding for the CFTC of \$160.6 million. This represents an increase of \$14.6 million—a 10 percent hike—above the fiscal year 2009 enacted level of \$146 million.

Of the \$14.6 million in increased funding for next year, \$7.4 million is slated for increased compensation and benefit costs for a staff of 572; \$0.2 million will be devoted to increased operating costs for information technology modernization, lease of office space, and other services; and \$7.8 million will support the salary and expenses of 38 additional full-time staff.

Last August, I had the opportunity to visit the CFTC's Chicago Regional Office. I met with a group of dedicated staff committed to doing outstanding work under challenging circumstances. I learned first-hand just how thin the staffing is.

The CFTC's Chicago market surveillance staff consisted of 10 economists who conduct daily oversight of each actively traded market and 6 trading specialists who process the daily reports detailing traders' actual positions in each market.

These economists are responsible for surveillance of over 1,250 different commodity futures and option contracts, of which 325 are active, involving 13 different commodity types. The commodities underlying the futures contracts the staff must monitor are highly diverse—including grains, livestock, lumber, currencies, Treasury instruments, equity indexes, single stock future, and dairy. More recently, weather derivatives, real estate indexes, and environmental products such as carbon credits and emission allowances became part of their portfolio.

A single staff economist must cover many markets. For example, one staffer is responsible for 10 grains, one for 90 currencies, and one for the surveillance of over 500 hundred single stock futures. Aside from supervision by the chief of the Chicago surveillance section and Washington, DC supervisory personnel, there is limited redundancy built into the system. As a consequence, each one of those economists is critical.

The six trading specialists maintain an extensive daily data-gathering and verification system by collecting reports from exchanges, futures industry firms, and traders. As our energy debate in Washington throughout the last Congress demonstrated, this data collection is very important to the Commission's oversight and to market transparency.

As I pledged since assuming the Chairmanship of this committee, I am serious about addressing the resource deficiency facing this agency.

I will appreciate hearing from both Chairmen their honest appraisals about the resources they will require to achieve their missions, keep pace with change, and become as sophisticated as, if not more so, than the entities they monitor—while responsibly managing taxpayer dollars.

Senator DURBIN. And I now turn it over to my Ranking Republican Member, Senator Collins.

STATEMENT OF SENATOR SUSAN COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Let me begin by saluting you for your leadership on this subcommittee. I am just delighted to be your new ranking member.

About two decades ago, I spent 5 years in Maine State government as a financial regulator overseeing the bureau of banking, insurance, securities administration, and I have a great personal interest in this area because I know that the decisions made by the SEC and the CFTC do, as you have pointed out, have such an impact not only on our economy but on the daily lives of most American families.

So it's a great honor to serve with you as your ranking member and I very much look forward to working cooperatively with you throughout this Congress.

As we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, let me also salute the chairman for his

leadership in securing significant increases for both of these agencies.

Thanks to the work of this subcommittee and the chairman's leadership, the budget for the SEC is now nearly 9 percent above the fiscal year 2007 funding level and the budget for the CFTC is 49 percent above that year.

These increases are extremely important, given that both of these agencies were woefully underfunded for years. I personally believe that they're still underfunded and that more work needs to be done.

I want to congratulate the two chairmen for appearing before our subcommittee today with aggressive agendas for change and reform. I look forward to hearing the details about the budget requests.

As the chairman has indicated, the current economic crisis has left our markets in turmoil and the loss of trillions of dollars of value in these markets has depleted family savings, shuttered small businesses and damaged retirement and pension funds.

I am convinced that we not only need to make sure these two agencies have the resources necessary but that we need to proceed with regulatory reform, as well, in order to restore confidence in our markets and to prevent the root causes of the current financial crisis from springing up once again.

Mr. Chairman, I am going to follow your lead and submit the remainder of my statement, as well, but I am delighted to be joining you to work on these critical issues.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SUSAN COLLINS

Good morning. At this first hearing of our subcommittee, I want to thank you, Chairman Dnrbin, for your leadership. This Subcommittee has jurisdiction over a diverse group of agencies, many of which have a profound impact on the financial stability of our economy and on the lives of most Americans. So it is an honor to serve with you as Ranking Member of this subcommittee, and I look forward to working cooperatively with you during this Congress.

Mr. Chairman, as we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, I want to salute you for your leadership in securing significant increases for both these agencies during your chairmanship of this subcommittee. Thanks to your hard-fought efforts, the budget for the SEC is now 8.9 percent above the fiscal year 2007 funding level, and the budget for the CFTC is 49 percent above the fiscal year 2007 level. These increases were extremely important, given that both of these agencies had been woefully underfunded over the years.

Chairman Schapiro and Chairman Gensler: Congratulations and thank you both for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2010 budget requests and the key efforts that you plan to undertake this year. You both have crucial roles in our economy: SEC, by protecting the public through enforcement of securities laws, and CFTC, by protecting market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options.

Protecting investors is more compelling than ever since many first-time investors have turned to the markets to help secure their retirements, pay for homes, and send their children to college.

Our current economic crisis has left our markets in turmoil. The loss of trillions of dollars in value in these markets has depleted family savings, shuttered small businesses, and damaged retirement and pensions funds.

Chairman Schapiro, I am troubled by reports that an environment of lax oversight and enforcement at the SEC was a contributing factor to the current financial crisis. For example, some investment banks were allowed to become over-extended, which

led to the collapse of several of Wall Street's largest banks. The Bernard Madoff ponzi scheme went undetected for decades, resulting in \$50 billion in investor losses. So Madam Chairman, I am pleased that you have developed an ambitious agenda of management reforms for the Commission, and I am interested in hearing what resources you need to accomplish these reforms.

Chairman Schapiro and Chairman Gensler: You both have challenging tasks in front of you. You must improve transparency in our securities markets and uncover fraud and deception, while not over-regulating our markets and hindering our economic recovery. I look forward to working with both of you, and with Chairman Durbin to ensure that you have the resources and the tools you need to ensure investors are protected and that markets are functioning properly.

I look forward to your testimony and I thank you for your service to our Country. Thank you, Mr. Chairman.

Senator DURBIN. Thanks a lot, Senator Collins.

Senator Tester, would you like to make an opening statement?

Senator TESTER. Thank you, Mr. Chairman.

Just to welcome Mary and Gary to the subcommittee today. I appreciate the work that you have done and I appreciate the work you are about to do. I think it's critically important that we have good, solid, reasonable enforcement and I think both of you are up to that challenge.

So with that, we'll move on. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Tester.

Chairman Schapiro, the floor is yours.

Ms. SCHAPIRO. Chairman Durbin, Ranking Member Collins, and Senator Tester, thank you very much for the opportunity to testify today.

In the short time that I've been at the SEC, we have taken on an active agenda, all with the goal of protecting investors, revitalizing the agency, and restoring confidence in the markets. We are making great strides, yet recognize that we have quite a distance to go.

In the area of enforcement, we have changed our policies so that our investigators do not have to jump over unnecessary hurdles before seeking penalties or launching investigations. We have hired a former Federal prosecutor to lead the Enforcement Division, someone who is focused on bringing significant cases with a meaningful impact as quickly as possible and ensuring that the Division is appropriately organized to do just that.

We have begun to update our management systems, to upgrade our risk assessment capabilities so that we can better detect fraud, and we have expanded and improved upon our training so that our staff will be able to keep pace with the new financial products and strategies created on Wall Street.

Already we are seeing results. Since the end of January, as compared with the same period last year, we have filed nearly three times as many temporary restraining order cases, issued more than twice as many formal orders and opened over 20 percent more investigations into fraud.

Although enforcement is central, it is still just one part of our agency. As you know, we are tasked with overseeing broker-dealers, investment advisors, and mutual funds, and we are taking steps to improve our ability to do just that.

For instance, we are working on a risk-based initiative to improve our oversight methods so that we can better identify and focus resources on riskier institutions. We also are recruiting senior

professionals with new skill sets, such as trading, risk assessment and financial analysis, and we have created an Industry and Risk Management Fellows Program to bring top talent into the agency.

SEC'S RULEMAKING AGENDA

In addition to internal management directives, we also have engaged in an active rulemaking agenda. Last month, the SEC proposed significant changes to the rules governing investment advisors who maintain custody of their clients' assets.

Should the proposals be adopted, advisors with custody will have to undergo a surprise exam by an independent public accountant once a year to verify client assets and any custodian affiliated with an advisor would also be subject to custody controls reviews by an independent accountant. The goal is to expose Ponzi schemes and other frauds earlier.

In the area of short selling, the Commission unanimously voted to propose two distinct approaches to limit short selling. One would impose a permanent market-wide short sell price test, the other approach would impose temporary short selling restrictions upon individual securities during periods of severe price declines.

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. We will focus on tightening credit quality, maturity and liquidity standards for money market funds.

We're also exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value to better prevent abuses and avoid runs on the funds.

Additionally, I have asked the staff to undertake a comprehensive review of rule 12(b)(1) which allows mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses.

In the area of proxy access, the Commission already has proposed rules that would enhance the ability of shareholders to nominate company directors and next month we will take up a broad packet of corporate disclosure improvements around compensation policies, the use of compensation consultants, and the interplay between risk-taking and incentive arrangements.

But there is still more to do in the regulatory arena. We have been working closely with other Federal agencies to bring the unregulated world of credit default swaps into the sunlight.

Operating under the limitations of the current legislative structure, we recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps.

In the coming months, we will also tackle issues related to municipal market reform, stock lending, trading in non-transparent markets or dark pools, and hedge fund oversight. I look forward to working with Congress on these issues.

RESOURCES NEEDED FOR SEC'S MISSION

The financial crisis has reminded us all just how large, complex and critical to our economy the securities markets have become. At the SEC, our 3,700-person staff now oversees more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual

funds, 11,000 advisors, and 5,000 broker-dealers, and it is a number that is growing rapidly.

Nonetheless, during this same period the SEC's resources have fallen. Between 2005 and 2007, the agency saw 3 years of flat or declining budgets and lost 10 percent of its employees. This has an impact.

With support from this subcommittee during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce, and I am very grateful for that support.

But even with these important steps, the number of staff remains below the levels of only a few years ago. I believe additional resources are essential to restoring the SEC as a vigorous and effective regulator.

The President has requested a total of just over \$1 billion for the agency in fiscal year 2010, a 7 percent increase over this year's level. This budget request would permit us to fully fund an additional 50 staff positions over 2008 levels. These positions would help the SEC's Enforcement Program enhance its pursuit of tips and complaints and fully fund our new Fellows Program that brings in seasoned industry professionals.

In addition to expanding our workforce, the President's request also would enable us to invest more in new technology, a budget item that has dropped by more than one-half in the last 4 years.

Mr. Chairman, I came to the SEC to shape public policy in the interest of investors and to strengthen our Enforcement Program. The measures I have described today are important to those efforts, but what I have also discovered is that we cannot neglect the internal operations of the agency, the processes that guide our work and the agency's infrastructure.

I am committed to a complete review of the internal operations to ensure that we meet the highest standards and that we are fully supporting the important work of our employees. To ensure that we do it right, I intend to bring in a chief operating officer to manage that process.

I want to thank you for your continued strong support of the SEC and its critical mission. I believe that by strengthening our Enforcement Program, enhancing risk-based oversight, and leveraging technology, we can restore investors' confidence in both the SEC and in our Nation's securities markets.

PREPARED STATEMENT

I look forward to answering your questions. Thank you.
 Senator DURBIN. Thanks, Chairman Schapiro.
 [The statement follows:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

Chairman Durbin, Ranking Member Collins, Members of the Subcommittee, thank you for the opportunity to testify today. I sincerely appreciate the support this Subcommittee has shown the Securities and Exchange Commission, and I am pleased to have the opportunity to discuss with you the Commission's role in helping to address the financial crisis, and to discuss reforms to improve investor protection and restore confidence in our markets.

The last year has been a wrenching time for the investors whom the SEC is charged with protecting. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink dramatically as a result. The economic crisis

has challenged faith in our system of capital formation and allocation—a system that has proved over the long term to be the greatest for creating wealth the world has seen.

As an agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, we are dedicated to understanding and learning from recent events and from the causes that were building in the system over the years, so that we can do our part to restore market integrity and investor confidence. The SEC must act promptly, decisively, and with resolve. We also must have a renewed commitment to protecting investors; they provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is the foundation upon which all our responsibilities are built.

To that end, I've already announced several changes at the agency that will reinforce our focus on investor protection and market integrity and redirect our energies toward restoring investor confidence.

REINVIGORATING SEC ENFORCEMENT

One of my very first actions as Chairman was to end the 2-year "penalty pilot" program, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases where the staff sought fines against public companies that violated the law. Some enforcement staff had complained that the procedures unnecessarily delayed the prosecution of cases, and discouraged the staff from either seeking a penalty or seeking an appropriately high penalty. At a time when the SEC needs to send a clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff, the penalty pilot program was an unnecessary hurdle to more active enforcement.

Another change I implemented to bolster the SEC's Enforcement program was to provide for more rapid approval of formal orders of investigation, which allow SEC staff to use the power of subpoenas to compel witness testimony and the production of documents. In investigations that require the use of subpoena power, time is of the essence; delay can be costly to an investigation. To ensure that subpoena power is available to the staff when needed, the agency has returned to a policy of timely consideration of formal orders by the serial process or, where appropriate, by a single Commissioner acting as duty officer.

In addition, I have hired a new enforcement director, a longtime Federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force, charged with focusing our enforcement efforts on bringing meaningful, high impact cases quickly. We are working together on management reforms—including harnessing technology, improving risk assessment, and improving training and supervision for our line law enforcement personnel—so that we can maximize our resources to combat fraud and wrongdoing in our markets. Our Division of Enforcement has been working diligently. Since the end of January,

—We have filed at least 34 emergency temporary restraining orders. During roughly the same period last year, we filed 12.

—We have opened more than 358 investigations. During roughly the same period last year, we opened 292.

—The Commission has issued at least 188 formal orders. During roughly the same period last year, the Commission issued 74.

Since January, we have brought a number of important and complex cases. For example, in the Reserve Fund matter filed in May, we charged certain operators of the Reserve Primary Fund, a \$62 billion money market fund whose net asset value fell below \$1.00 or "broke the buck" last fall, with fraud for failing to provide key material facts to investors and trustees about the Fund's vulnerability as Lehman Brothers Holding, Inc., sought bankruptcy protection. As part of this action, we are seeking to bring about an expedited, efficient, and equitable pro-rata distribution to shareholders of the Fund's remaining assets, including \$3.5 billion originally set aside in the Fund's litigation reserve.¹ We believe this will help Reserve Fund investors recover a larger share of their assets.

In March, we initiated a case alleging fraud in connection with a kickback scheme involving New York's largest pension fund. Namely, we charged New York's former Deputy Comptroller and a top political advisor with extracting kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since March, we have amended the complaint to add additional defendants, including a former New York State political party leader, a

¹SEC v. Reserve Management Company, Inc., et al., Lit. Rel. No. 21025 (May 5, 2009).

former hedge fund manager, a Dallas-based investment management firm and one of its founding principals, and a Los Angeles-based "finder."²

As committed as we are to vigorous enforcement of the securities laws, we are also mindful that the complexity of 21st century markets, as well as the varied nature of frauds and scams, require that the sophistication and tools available to our Enforcement and Examination programs keep pace. Important questions have been raised concerning the agency's handling of tips or whistleblower information related in particular to the activities of Bernard Madoff. Clearly this is something we must learn from, and I am committed to addressing it. Former Chairman Cox asked the SEC Inspector General to look into what happened, what failed to happen, and to report back to the Commission. We expect to receive the IG report this summer and will promptly take all appropriate actions and address any remaining shortcomings.

It is clear that, regardless of any findings of the Inspector General, the agency must improve its ability to process and pursue appropriately the hundreds of thousands of tips and referrals it receives annually. In February, we retained the Center for Enterprise Modernization which began work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. We are in the process of creating a system that will centralize this information so we can track it, analyze it and more effectively identify valuable leads for potential enforcement action and compliance exams.

STRENGTHENING EXAMINATION AND OVERSIGHT

In addition to these changes, it is essential that we work to improve our risk-based oversight of broker-dealers, investment advisers and mutual funds. Our Office of Compliance Inspections and Examinations (OCIE), together with other agency staff in the Office of Risk Assessment, are presently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk. OCIE has improved training and, under a newly authorized program, 268 examiners are now participating in the training and certification program offered by the Association of Certified Fraud Examiners, to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. OCIE is also recruiting additional individuals with experience in different facets of the industry, such as trading, risk assessment and compliance. These steps taken together will expand the knowledge base of our inspections staff, better enabling them to conduct oversight of complex trading strategies and products that exist in our markets today.

I have also launched an Industry and Markets Fellows Program in our Office of Risk Assessment. Through this program, we have begun recruiting fellows with extensive experience in such areas as equity and fixed income securities trading, structured products, complex derivatives, financial analysis and valuation, fund management, investment banking and financial services operations.

IMPROVING TRANSPARENCY AND INVESTOR PROTECTION

The agency is working hard in other areas as well. In the area of accounting standards, the SEC staff completed a congressionally-mandated study of fair value accounting. The staff issued guidance to financial institutions so that they can give fuller disclosure to investors, particularly with respect to hard-to-value assets. The staff has also continued to work closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets and the accounting treatment of bank support for money market funds. FASB recently took steps to clarify treatment of off-balance sheet items in a manner designed to increase market transparency.

In the area of combating false rumors and manipulative activity in the marketplace, the agency initiated examinations of the effectiveness of broker-dealers' and investment advisers' controls to prevent the spreading of false information. When concluded, the results of these examinations will be used by regulators to assist firms in crafting and implementing robust policies and procedures to prevent the spreading of false information.

In the wake of recent Ponzi schemes and other investment adviser abuses, the Commission last month proposed significant changes to the custody requirements for investment advisers. These proposals focus on the value of an independent public accountant serving as another set of eyes to better assure the safekeeping of investor assets. One proposal would require all advisers with custody or control of client

² SEC v. *Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009), Lit. Rel. No. 21036 (May 12, 2009).

assets to engage an independent public accountant to conduct an annual “surprise exam” to verify those assets exist. A second proposal would apply only to investment advisers whose client assets are not held by a firm independent of the adviser. In such cases, the investment adviser would be required to be subject to a review that results in a written report—prepared by a PCAOB-registered and inspected accounting firm—that, among other things, describes the controls in place relating to custodial services, tests the operating effectiveness of those controls and provides the results of those tests. These reports are commonly known as SAS-70 reports. The reports would include an opinion of an independent public accountant issued in accordance with the standards of the PCAOB, which will provide an important level of quality control over the accountants performing this review. In addition, advisers would be required to publicly disclose the name of the accountant conducting these reviews, so that our staff can better monitor compliance and assess adviser compliance risks. Accountants also would be required to disclose the reason for any termination or resignation from performing these reviews, which should highlight any “red flags” for regulators and investors.

At my request, our staff is also developing investor-oriented enhancements to the municipal securities area. It is time for those who buy the municipal securities that are critical to State and local funding initiatives to have access to improved quality, quantity and timeliness of information. On a related note, so called “pay-to-play” practices by investment advisers to public pension plans must be curtailed. I have asked the staff to revisit the Commission’s 1999 proposal to address harmful pay-to-play practices, and I expect that the Commission will consider that proposal this summer.

COMBATING ABUSIVE SHORT-SELLING

In my brief tenure as Chairman, the issue of short selling has outpaced any other in terms of the number of inquiries, suggestions and expressions of concern we have received. On April 8, 2009, the Commission unanimously voted to propose two distinct approaches to short selling restrictions. One approach would impose a permanent, market-wide short sale price test, while the other would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities. On May 5, 2009, the Commission held a public roundtable to solicit the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. The Commission is committed to conducting a thoughtful, deliberative process to determine what is in the best interests of investors, including examining a variety of trading and market related practices such as securities lending.

We also recognize that strong rules and vigorous enforcement are needed to curb abusive short selling and restore confidence in our markets. The Commission has been focused on the issue of abusive “naked” short selling since before my arrival in late January, and the Commission’s regulatory actions have led to a significant decline in failures to deliver securities on time following a short sale. Moreover, our Division of Enforcement has a number of active investigations involving potentially abusive short selling in a variety of contexts.

FILLING REGULATORY GAPS

In an effort towards bringing the unregulated world of credit default swaps into the sunlight, the Commission, working in close consultation with the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission (“CFTC”) and operating under the limitations of the current legislative structure, recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps (“CDS”) by I.C.H. Clearnet Ltd., ICE US Trust LLC, and Chicago Mercantile Exchange Inc. The Commission is committed to increasing investor protection and reducing systemic risk by facilitating the development and oversight of central counterparties to clear CDS.

We have also been working with the CFTC and Treasury Department to fill regulatory gaps in this area to help increase transparency and minimize risks associated with certain derivative products, including CDS, as well as market participants transacting in these products. I look forward to working with Congress to make the necessary legislative changes to ensure that these markets and market participants are appropriately regulated.

In addition, we are closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct applicable to broker-dealers and investment advisers. It is essential that comparable and effective protections be afforded to investors, whether they

turn to a broker-dealer or an investment adviser for assistance in accessing the securities markets.

Finally, hedge funds and other unregulated private pools of capital have flown under the radar for far too long. We are currently examining whether these funds, their managers or both should be subject to SEC registration and oversight, so that investors, regulators and the marketplace have more complete and meaningful information about the funds and their market activities. I look forward to working with Congress on this important issue.

STRENGTHENING SHAREHOLDER RIGHTS

We have launched an agenda of proxy reforms with a proposal approved by the Commission for public comment that would significantly support shareholders' rights to nominate company directors. Next month we will take up a broad package of corporate disclosure improvements, all designed to provide shareholders with important information about their company's key policies, procedures and practices, including compensation policies and incentive arrangements. With this additional information, shareholders will be better able to hold directors accountable for the decisions that they make. For example, the Commission will consider proposals to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission will also consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure (whether that structure includes an independent chair or combines the positions of CEO and chair), so that shareholders can better evaluate board performance. Also, shareholders should understand how compensation structures and practices drive an executive's risk-taking. The Commission will be considering whether greater disclosure is needed about how a company—and the company's board in particular—manages risks, both generally and in the context of compensation. The Commission will also consider whether greater disclosure is needed about a company's overall compensation approach, beyond decisions with respect only to the highest paid officers, as well as about compensation consultant conflicts of interests.

IMPROVING MONEY MARKET AND MUTUAL FUND REGULATION

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. The proposals will focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets, like those that unfolded last fall. In addition, we are exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value, in order to protect investors from abuses and runs on the funds.

In addition, on June 18, the SEC and the Department of Labor will hold a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become quite popular, and growth in target date fund assets is likely to continue since these funds can be default investments in 401(k) retirement plans under the Pension Protection Act of 2006. However, target date funds have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results. Returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

These returns cause concern for investors and regulators alike. I can assure you that SEC staff is closely reviewing target date funds' disclosure about their asset allocations. In addition, in connection with our joint hearing with the Department of Labor, we will consider whether additional measures are needed to better align target date funds' asset allocations with investor expectations. Among other issues, we will consider whether the use of a particular target date in a fund's name may be misleading or confusing to investors and whether there are additional controls the SEC should impose to govern the use of a target date in a fund's name.

I also have asked the staff to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Yet in 2008, rule 12b-1 was used to collect over \$13 billion in investors' funds out of fund assets. It is essential, therefore, that the SEC engage in a com-

prehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to step in and adjust our regulations.

In addition to these initiatives, the agency continues to annually review 5,000 corporate filings, over 1,000 SRO rules, and nearly 3,000 new investment company portfolio disclosures. We establish the standards for 13 securities exchanges, 4 securities futures product exchanges, FINRA (a national securities association), the Municipal Securities Rulemaking Board, 10 nationally recognized statistical rating organizations, 10 registered clearing agencies, approximately 600 transfer agents, and securities information processors. Despite the extreme volatility and uncertainty in the markets over the past year, transactions continue to trade at both record volumes and record speed.

SEC RESOURCES

The financial crisis has reminded us just how large, complex, and critical to our economy the securities markets have become in recent years. Whereas the dollar value of the average daily trading volume in stocks, exchange-traded options and security futures was \$10 billion a day in February 1989, over the last 20 years it has grown to over 25 times that size, reaching approximately \$251 billion a day in February 2009. And not only has the size of our markets exploded, the number and size of its participants have jumped as well. For example, since 2005, the number of registered investment advisers has increased by 32 percent, and their assets under management have jumped by over 70 percent to reach more than \$40 trillion as of the beginning of this fiscal year. Broker-dealer operations have expanded significantly in size, complexity, and geographical diversity, as exemplified by the 67 percent rise in the number of broker-dealer branch offices. In all, the SEC's 3,652 staff now oversee more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual funds, 11,300 investment advisers, 5,500 broker dealers, and 600 transfer agents. By comparison, other financial regulators often have close to parity between the number of staff and the number of entities they regulate. For additional detail, attached to this testimony is an appendix, "SEC Staff Levels Have Not Kept Pace with Industry Growth."

Yet at the same time that the securities markets have undergone such tremendous growth, the SEC's resources have fallen further and further behind. Between fiscal year 2005 and fiscal year 2007, the agency experienced 3 years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs. In the context of rapidly expanding markets, I believe these reductions in the SEC's staff seriously limited the agency's ability to effectively oversee the markets and pursue violations of the securities laws.

With support from this subcommittee, during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce. By increasing the SEC's appropriation for this fiscal year, approving a reprogramming of additional resources, and just recently supporting emergency supplemental funds for the agency, this subcommittee has expressed its strong support for the SEC and its mission. I am very grateful for that support.

However, even with these important steps, the number of staff with which the SEC can detect fraud, prosecute wrongdoing, ensure proper disclosure, conduct strong oversight of the markets, and take other actions to protect investors, is still significantly below the levels of only a few years ago. Under the SEC's current funding level, the agency's workforce still will fall about 200 staff, or about 5 percent, short of the fiscal year 2005 level.

I believe additional resources are essential if we hope to restore the SEC as a vigorous and effective regulator of our financial markets. The President is requesting a total of \$1.026 billion for the agency in fiscal year 2010, a 7 percent increase over the fiscal year 2009 funding level. This proposal would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance our ability to uncover and prosecute fraud, and begin to build desperately needed technology.

Specifically, these positions would help the SEC's Enforcement program enhance its pursuit of tips, complaints and other leads, thus increasing the resources the SEC can dedicate to frauds that citizens bring to our attention. They would also allow us to hire more trial lawyers and staff with specialized skills that will help our Enforcement program's efficiency, expertise and success. The Examination program would hire market experts to strengthen risk-based oversight of the investment management industry and expand its inspections of credit rating agencies. Our Division of Trading and Markets would strengthen its oversight of entities that play critical roles in our markets, such as broker-dealers, exchanges, clearing cor-

porations, and other self-regulatory organizations. And the President's Budget would allow us to expand our Office of Risk Assessment by fully funding our program to bring in seasoned industry professionals to help uncover hidden risks to investors.

Although expanding our workforce is a critically important step, I believe we also must give our staff better tools to conduct oversight of vast financial markets. That is why the President's request for fiscal year 2010 also contains funds for additional investments in our information systems. Investments in new systems have dropped by more than half over the last 4 years, and as a result the SEC has a growing list of technology needs that have gone unfunded. With the additional IT funds provided under the President's Budget for fiscal year 2010, I would plan to focus on several key projects:

First and foremost, we would use additional funds to enhance our systems for handling tips, complaints and referrals. Although the SEC has a number of different processes to track this kind of information, there is no central repository or system through which this information comes together to ensure it is handled consistently or appropriately. Nor is there any present capability to mine the data to find connections, patterns or trends that would enable us to more intelligently focus our enforcement efforts.

The SEC also plans to improve our ability to identify emerging risks to investors. We have many internal data repositories from filings, examinations, investigations, economic research and other ongoing activities. But the SEC needs better tools to mine this data, link it together, and combine it with data sources from outside the Commission to determine which firms or practices raise red flags and deserve a closer look.

Finally, we would invest in our multi-year efforts to improve the case and exam management tools available to our enforcement and examination programs. These systems would give our senior managers better information on the mix of cases, investigations, and examinations, so they can apply resources swiftly to the continually evolving set of issues and problems in the markets. In addition, these tools will provide better support for line staff in these programs, so they can be more productive and better able to match the sophisticated systems used by the financial industry.

I came to the SEC to shape public policy in the interest of investors and to strengthen our enforcement program. The things I have described in this testimony are important to those efforts. But what I have also discovered in the past 4 months is that much attention needs to be focused on the internal operations of the agency, the processes that guide our work, the agency's infrastructure and how we are organized. I have been disappointed to find that in some areas of our internal operations, we fall short of what the taxpayer has a right to expect of us, and what our employees have a right to expect of a world class organization. I am committed to a complete review of areas large and small, including FOIA operations, call centers operations, records management, and others, to ensure that we meet the highest standards and that we are fully supporting the important work of our employees in these operations. Doing this will take time and energy and focus. To ensure that we do it well and thoroughly, I intend to bring in a Chief Operating Officer to manage the process. Federal agencies do not manage themselves; we must be actively engaged in that process everyday.

In one area, we have already made progress: we are moving to build an internal compliance program that is second to none. The public appropriately holds the SEC to a very high standard for integrity and professionalism, and we hold ourselves to that very high standard as well. That is why I have initiated several steps to guard against inappropriate securities trading by SEC staff, as well as to avoid any appearance of inappropriate trading. Among other steps, the agency has drafted new internal rules that would prohibit staff from trading in the securities of companies under SEC investigation, regardless of whether an employee has personal knowledge of the investigation, and require preclearance of all trades. The SEC also is contracting with an outside firm to develop a computer compliance system to track, audit and oversee employee trades and financial disclosures in real time. Finally, I consolidated responsibility for this area within our Ethics Office and authorized the hiring of a new chief compliance officer. To further enhance the SEC's financial controls, the agency also will continue its multi-year efforts to build an automated, integrated financial management system.

I want to thank you for your continued strong support for the SEC and its critical mission. I believe the steps I have outlined here—strengthening our enforcement program, enhancing risk-based oversight of the markets and leveraging technology—are essential for restoring investors' confidence in both the SEC and in our Nation's securities markets.

I would be happy to answer any questions you may have.

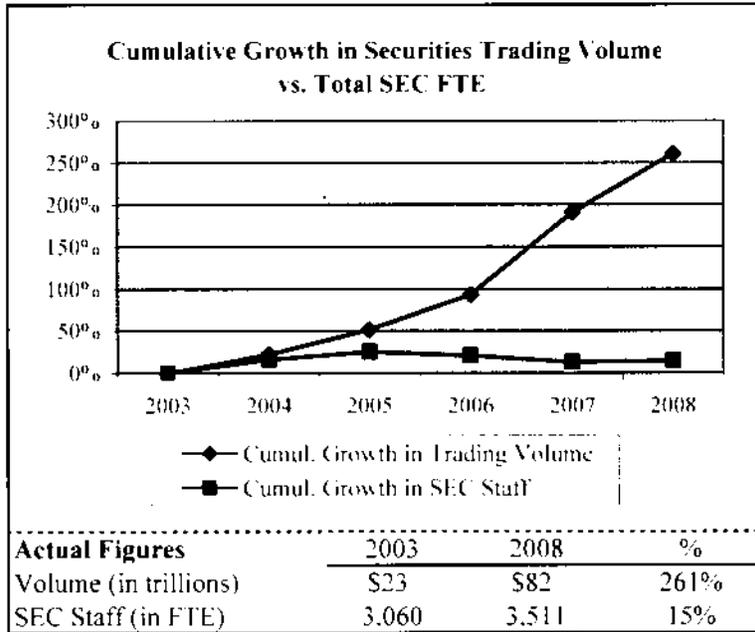
APPENDIX: SEC STAFF LEVELS HAVE NOT KEPT PACE WITH INDUSTRY GROWTH

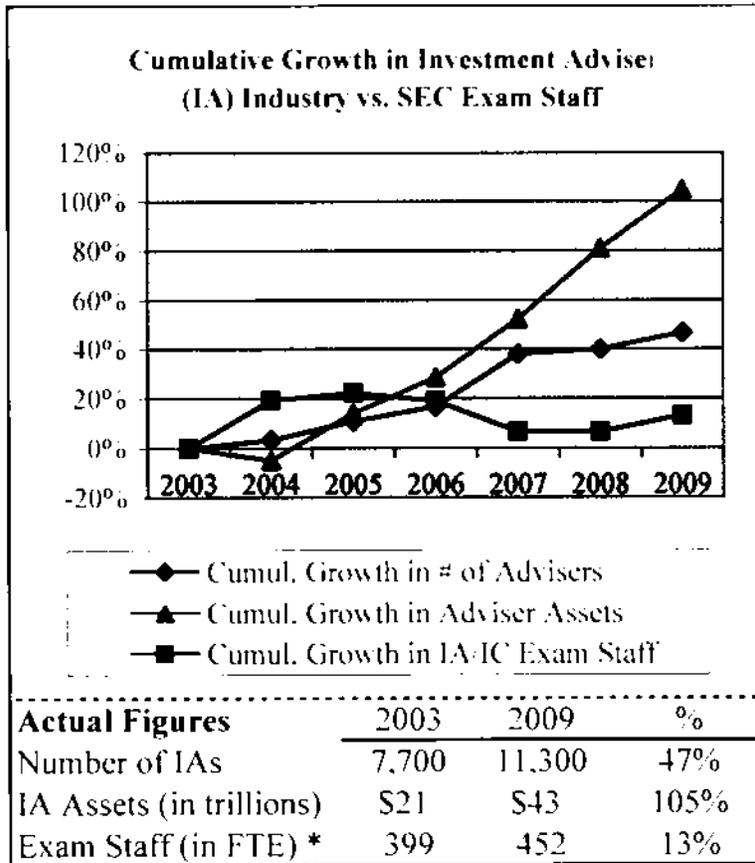
(Tables show cumulative growth relative to 2003 levels)

The SEC's staff of 3,652 FTE (estimate for fiscal year 2009) oversees more than 35,000 entities. These include:

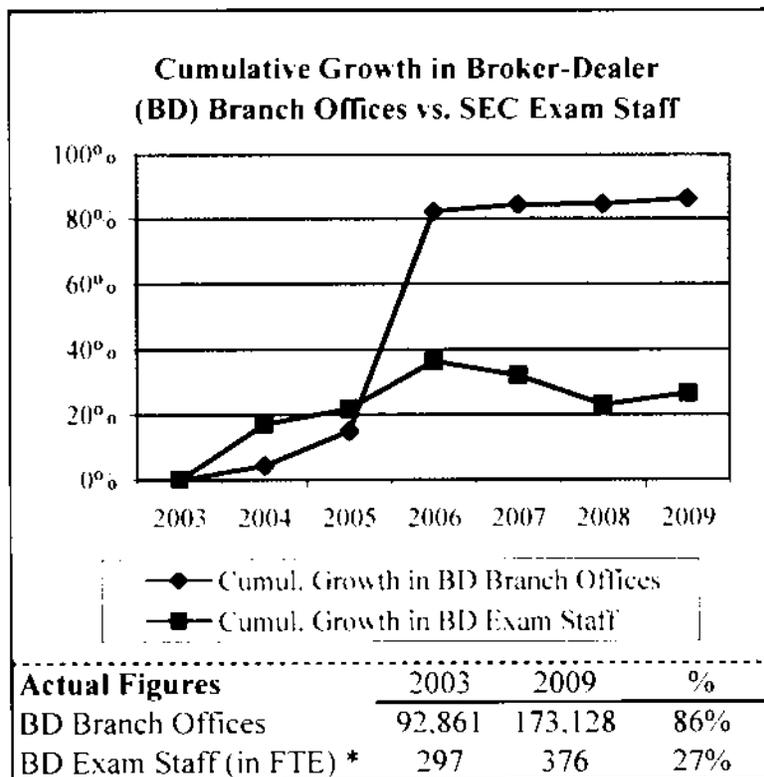
- 11,300 investment advisers;
- 5,500 broker-dealers;
- 8,000 mutual funds;
- About 600 transfer agents;
- Clearance and settlement systems;
- 11 securities exchanges;
- 12,000 public companies;
- 10 credit rating agencies;
- FINRA, MSRB, and PCAOB.

The following charts display how various aspects of the markets have grown since 2003, relative to the SEC's staff:





* The FTE figures for FY 2009 are estimates.



BUDGET AND WORKFORCE OF THE SEC

Senator DURBIN. We'll have 5-minute rounds here, and I'm sure we'll have several questions.

It seems to me that there are two things we're dealing with here just on the surface. First, the number of people working in your agency. It appears that over the years, as Senator Collins noted, we've allowed the number of professionals working there to decline in real terms and certainly decline precipitously in relation to the volume of trade that you have to keep an eye on.

Between 2005 and 2007, the SEC lost 10 percent of its employees, if you can imagine at that moment in time, undermining the agency's ability to oversee the markets, and at the same period of time, the market ballooned in size and complexity.

Registered investment advisors grew 32 percent, assets jumped by over 70 percent, and so we're seeing the caseload or at least the area that needs to be regulated is growing and the number of people to keep an eye on it is diminishing.

So there is, in the first instance, the question of the right number of people working at the agency, and the second issue goes to—I don't know how to characterize it—I guess the internal culture of the agency.

Bernard Madoff was a wake-up call. The fact that this man could swindle as many people as he did with impunity for so long to me is nothing short of amazing.

According to SEC data, in fiscal year 2008, the SEC staff handled over 600,000 tips sent by individuals to your Enforcement Complaint Center. I did a calculation. I think that's more than 2,000 a day for every business day. People sending in items you ought to look at. Well, that to me is an overwhelming number and perhaps you could put it in some kind of perspective.

Now, some have taken a look inside your agency and asked whether the enforcement function within the agency is a healthy one. Is there a risk-averse culture within the SEC to step up and say, you know, we ought to take a look at this Mr. Madoff or people like him?

So let me ask you at the outset, number 1, what would be the optimal number of people that you believe you need to do an effective job at the SEC in light of the volume of business that you have to regulate, and second, do you perceive a cultural problem within the agency when it comes to enforcement?

Ms. SCHAPIRO. Thank you very much, Mr. Chairman.

I think you've really summarized very well with respect to the staffing pressures on the SEC, the current situation.

With over 35,000 regulated entities and 3,700 staff, it's a job that we really can't do in the way I think the public would like to believe we can do in the sense of routine onsite presence in many regulated entities. That's going to really require that we leverage third parties.

So, for example, in the rules I discussed related to the custody of customer assets by investment advisors, a huge problem in the Madoff area, we're going to rely on PCAOB-registered accounting firms to leverage our capability to ensure the customer assets are being protected by the custodians and by the investment advisors, and we will look for every opportunity we can to leverage third party resources.

But at the end of the day, we do need significantly more staff, I believe, over the next several years to keep up with the growth and the complexity of this industry, and if there are additional responsibilities as a result of regulatory reform that accrue to the SEC in the context of hedge funds, credit default swaps or other areas, that, of course, will require sufficient additional resources because we can't stretch any thinner than we already are.

So I do believe—and if you look at our 2011 budget request, you will see we've asked for a significant ramp-up in the number of full-time equivalents (FTE), close to 400 FTE and 1,000 new positions, and I believe that if we're able to achieve that number in 2011 or over the course of the next several years, that will go a long way toward getting this agency to the appropriate size to handle the job that's in front of it.

I don't think there's any danger that we're about to become too big in any event.

I think, with respect to your second question, the Madoff fraud is a tremendous tragedy. It's really a tragedy of epic proportions and I think it really will put the onus on this agency to prove that it is capable of managing the responsibilities that it has been given

under the law and it's really critically important for us to ensure that both our culture, our operations, and our procedures, our staff and our skill sets are up to the task.

You pointed out, for example, that we get somewhere around 600,000 to, in peak years, 1½ million tips a year. We can't manage those that come into the organization through a wide variety of entry points. We don't have databases that are connected so that we can do a trend analysis of those tips and complaints or connect that data to external sources of data to see what might be developing more broadly in the marketplace.

Right after I started, I brought in the Mitre Corporation's Center for Enterprise Modernization to do a complete review of how we handle tips and complaints. They've concluded the first round of their work and we're now in the implementation phase of some short-term and intermediate-term remedies and processes to help us manage tips and complaints.

But it's also about leadership and it's about freeing our Enforcement Division to do the kind of job that I know they're capable of doing.

I was at the SEC 15 years ago when the agency had a really first-class reputation for aggressive enforcement and I know we're capable of that again. We have a new Enforcement Director who's very committed to bringing large cases in a timely way that have the maximum investor protection impact.

It's about enabling our enforcement staff through technology and the right skill sets to bring those kinds of cases, that when a whistleblower presents them with information, as had happened in the *Madoff* case, they have the ability to understand it and pursue it. It's about being a little bit humble about the information that comes to us and appreciating that there may be real value in what's being presented to us.

We're also going to seek whistleblower legislation to enable us to reward whistleblowers, as the Internal Revenue Service (IRS) and other agencies do, when they bring us well-formed cases and documentation, a fraud that we can then pursue, and it's about filling the regulatory gaps, through such as the custody requirements I just spoke of, so that we are sure that the regulatory regime, coupled with aggressive enforcement, coupled with the tools and the skill sets, combine to create an agency that's absolutely committed and focused on investor protection.

I'm sorry. That's a very long answer.

Senator DURBIN. No. It's a very good answer, and I thank you for it, and I'm going to turn to Senator Collins and return in later rounds.

Senator COLLINS. Thank you, Mr. Chairman.

Ms. Schapiro, you talked about the increased number of positions that you have requested as part of the fiscal year 2011 budget, but in fact, the President's budget for this coming fiscal year does not allow you to hire any new positions, is that correct?

Ms. SCHAPIRO. That's correct, Senator. The increase in the 2010 budget covers the annualized costs of the increases in the fiscal year 2009 budget that we were able to have as a result of the approval of our reprogramming requests and taking \$17 million of

unobligated funds from prior years, dedicating those to staffing, additional staffing in 2009.

The annualized costs of those additional 50 positions that we're bringing on this year are the increase in the 2010 budget.

Senator COLLINS. Do you need new positions for the upcoming fiscal year?

Ms. SCHAPIRO. Well, I would say that we're, first of all, extremely grateful to the President for the increase in the 2010 budget and it's a meaningful increase for this agency, and as I pointed out, 2011 we sought a much greater increase.

The opportunity to start to move toward that 2011 budget earlier would be a wonderful opportunity for us to bring that number of staff on over a 2-year period rather than all in 2011, if Congress ultimately approves that number.

Senator COLLINS. Because I am troubled that the current funding level supports a staff that is 5 percent lower than your peak level back in fiscal year 2005.

If you look at the growth of regulated entities and if you look at the amount of money involved, if you look at the number of American families who now have savings in the stock market, the fact that these staffing levels are below what they were 5 years ago is troubling to me.

So are you saying that it would be helpful to be able to ramp up those staffing starting in the next fiscal year rather than waiting to fiscal year 2011?

Ms. SCHAPIRO. Absolutely, it would be helpful. The reprogramming request, in addition to allowing us to get a little bit of a jump on 2010, enabled us to do some technology investment.

We need fundamentally more investment in technology at the SEC to support our Enforcement and Examination Programs and we can use more boots on the ground in Enforcement and Examination, absolutely.

INVESTOR PROTECTION AND EDUCATION

Senator COLLINS. Aggressive enforcement is absolutely critical, but there's another way that's important for protecting investors, particularly smaller investors who may be less sophisticated in choosing their investments, and that is through a robust education effort.

You've spoken a lot about the need to protect investors and I know that in my State, I've seen thousands of individuals who have seen their retirement nest eggs shrink, money set aside for their children's college education virtually disappear, and they're wondering what can be done about it. They're seeking more information.

Several years ago, the SEC used to conduct very valuable educational sessions, town meetings, outreach to seniors groups.

What are your plans to reach out to investors, particularly small investors or senior citizens, in two ways; one, to help them better understand risk and suitability requirements, but, two, to help them spot scams?

Ms. SCHAPIRO. It's a wonderful question, and I'm very committed and personally quite passionate about investor education and had a program at my former employer, FINRA, as Senator Tester

knows, where we did investor forums which the SEC used to do years ago around the country and to great success and with tremendous participation all over the country.

The SEC has a small program that does that now. Commissioner Walter in fact did an investor forum just last week with our Boston office in the State of Maine.

My plans would be, given sufficient resources, that we dramatically increase that program, that we enable our offices around the country to provide local education in senior citizens centers, community centers, local high schools, and that we really take a leadership role in the Federal Government in educating investors about the kinds of questions they need to ask when they're being offered investment products, about the kinds of scams and pitfalls that they need to be on the alert to.

I'm very concerned, given the current environment and the amount of money people have lost in their retirement plans and in their other investments, that they will be reaching to try to make that money back through some particularly risky investments. I have no doubt that the scam artists have already figured this out and are beginning to prey on people's real fears about their financial futures.

I think the SEC can play a critical role here, bringing together other agencies of the Federal Government but also on its own, reaching out very directly as well as through the development of content put on websites and in investor forums.

Senator COLLINS. Thank you. Glad to hear it.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

Chairman Schapiro, you come into an agency, the SEC, that has been around about 75 years and to be honest, from my perspective, probably come into it at a time when it's hit an all-time low as far as both morale and effectiveness. So you've got to rebuild this agency, I think, maybe not from the ground up but from the foundation up.

We've talked about manpower levels. If you have the technology that you spoke about, do you have a figure in mind about what the right number of people are for this agency, considering the massive workload?

Ms. SCHAPIRO. I think it's very hard to give an exact number. As I said, our 2011 budget request seeks 1,000 additional positions which would take us to just under 5,000. That would still be smaller, for example, than the Federal Deposit Insurance Corporation (FDIC) which regulates about 5,000 to 6,000 banks.

Senator TESTER. Okay.

Ms. SCHAPIRO. I do think there's also practical limitation on how many people you can just bring on board and train—

Senator TESTER. Right.

Ms. SCHAPIRO [continuing]. At any given time. The faster that we can move toward a substantial increase like that I think the better.

Senator TESTER. Okay.

Ms. SCHAPIRO. It also depends largely on our ability of effectively utilized technology to save on human resources.

Senator TESTER. Right on. Consumer confidence is one of the things that everybody's concerned about. Nobody—you know, we've lost a bunch of money. People's confidence is shaken.

RESTORING INVESTOR CONFIDENCE

What do you see as being two or three of the major things that you have to do in your agency to have consumer confidence back at a level that's reasonable, and, quite honestly, what do you see we need to do, the two or three things that we need to do to help re-establish consumer confidence with the groups that you regulate?

Ms. SCHAPIRO. I think it's a great question. I think enforcement is just a part of what we do, but it's a very visible part, and I think it's really critical for investors to see that there is a cop on the beat who's trying to ensure that the playing field is level, that the insiders aren't taking advantage of the rest of the participants in the marketplace.

So we need to have a very timely enforcement response to the problems that arise in the marketplace and short of doing that, I think people won't have confidence. We can write all the rules we want, but if nobody's enforcing them, we're not going to restore investor confidence.

I think investors also need to have complete confidence in the transparency of corporate disclosure. They need to believe that the companies in whose stock they are buying are getting them the accurate numbers and the accurate disclosure and information about that company's prospects so they can make informed decisions about where to put their money.

And I think we have to have a focus on consumers issues, on mutual funds sales, on sales practices generally, on the issues around fees and fee structures and disclosures that investors really care about at the end of the day.

We'll be announcing later this week the creation of an Investor Advisory Committee for the first time in many, many years at the SEC that will give investors a regular way to interact with the Commission on policy issues that are of interest to them.

I think we have to reorient everything we do toward rebuilding the investor confidence in both the agency and in the fairness of our markets.

Senator TESTER. What do we need to do, Congress?

Ms. SCHAPIRO. I think supporting the agency, quite honestly, as the appropriators with sufficient resources to accomplish what we need to do and hold our feet to the fire that we're delivering on the commitments that we're making to the American public.

Senator TESTER. Have you been able—I mean, there's been talk about the future roles of the SEC, the CFTC that we'll hear from shortly, after a regulatory modernization has been done.

Assuming that that goes forward, can you talk about the challenges, opportunities, possible consequences of merging your two agencies?

Ms. SCHAPIRO. Sure. And, you know, I have the unique position of having been Chairman of the CFTC and now Chairman of the SEC. So in honesty, I can tell you I've argued both for and against merger over the years.

I think it's obviously a decision that's ultimately for the Congress about whether or not to combine the two agencies. Short of that, I believe that with Gary as Chairman of the CFTC that we can have an incredibly positive and constructive working relationship, to ensure that products and practices don't fall between the cracks of the two agencies and that we don't leave large swaths of the financial markets unregulated and unaccountable to the American public—

Senator TESTER. Do you think that would be—excuse me. Do you think that would be done better if you were combined?

Ms. SCHAPIRO. I think—in my personal view, there is a logic and an efficiency that can be achieved from the merger of the two agencies, but short of that, I also think that the two agencies can do a better job of working together to ensure the protection of investors.

Senator TESTER. My time is up, but we'll be back.

Senator DURBIN. I was just advised by my colleague that there's a vote on and I'm going to try to continue asking until someone returns, but I ask the indulgence of our witness and those in the audience as we try to balance a few things here.

ADDRESSING RESOURCE CONSTRAINTS

The numbers of investigative attorneys at the SEC decreased 11.5 percent between fiscal years 2004–2008 and some believe that that's resulted in delayed cases, reducing the number that can be brought to trial and potentially undermining the quality of cases that are pursued.

How have resource constraints impacted the effectiveness of the SEC?

Ms. SCHAPIRO. There's no question but that—and there's a recent Government Accountability Office (GAO) report that suggests this, as well, that the resource constraints have hindered the ability of the Enforcement Division to pursue as many cases in as timely a way as I would like to see.

In addition, there are some procedural difficulties placed in the path of the Enforcement Division over the last several years that slowed cases down and discouraged, if not explicitly, implicitly seeking penalties from corporate issuers in certain kinds of cases, and we've eliminated those hurdles and cases can be started much more quickly now. Investigations can be pursued with the approval of one commissioner, not the full Commission sitting in a meeting.

We've eliminated what was called the Penalty Pilot Program completely and we are reorganizing the Enforcement Division under the leadership of our new Director in a way that we hope will eliminate some layers of management and some of the stovepiping that's existed over the years and allow us to be more nimble and more aggressive, pursuing much larger cases, particularly those arising out of the financial crisis.

Senator DURBIN. On another issue, there was a mindset for a long period of time that as long as the economy was expanding and wealth was being created, we didn't dwell and ask a lot of embarrassing questions, but with the downturn in the economy, downturn in the fortunes of many families and the investment of our Federal Government into many of the largest businesses in Amer-

ica, there appears to be an awakening on the part of the average person about how many corporations are being managed and particularly in the area of executive compensation.

CORPORATE GOVERNANCE

I won't go into chapter and verse about bonuses given to executives who have nothing to show for it, other than failure, but let me ask you, what is the SEC currently doing to improve the accountability of corporate directors and enhanced disclosure of executive compensation?

Ms. SCHAPIRO. Mr. Chairman, I've made corporate governance one of my highest priorities in the last 4 months. We are engaged in a couple of things.

First of all, in May we approved for comment a proposal that will facilitate the ability of shareholders to nominate on the company's proxy directors to serve on the corporate—on the company's board and it's out for comment now. It will be highly controversial, but if ultimately approved and not challenged in court, it will greatly facilitate the abilities of shareholders to elect nominees to corporate boards and thereby hold directors more accountable for their oversight of the corporation.

With respect to compensation in particular, as you know, we already require disclosure of all plan and non-plan compensation by the senior-most officers of a company.

Next month we will be considering amendments to the compensation disclosure rules that will simplify something called the summary compensation disclosure table to provide more information there about compensation.

It will require disclosure about the overall compensation approach within the company. There will be enhanced disclosure about the use of compensation consultants who are sometimes in a conflicted position in advising both the compensation committee and the company's management, and we're going to require disclosure about the linkage between compensation plans and risk-taking by executives, traders and others within the company, so that investors will be able to understand how risk-taking which was such an important component of the financial crisis has been potentially incentivized in some companies.

CREDIT RATING AGENCIES

Senator DURBIN. On another issue, in late 2006 the Credit Rating Agency Reform Act gave the SEC exclusive authority over rating agency registration and qualification. In the less than 3 years since enactment the SEC has undertaken no fewer than five rulemakings to implement the law. These rules, which are all still relatively new, extend from registration and recordkeeping to disclosure and managing conflicts of interest.

Yet, even though the credit rating agencies were under SEC's purview, rating agency performance in the area of mortgage-backed securities backed by residential subprime loans and the collateralized debt obligations linked to such securities has shaken investor confidence to the core.

It used to be that credit ratings were kind of like the gold standard in terms of whether you could trust a business to be in solid financial shape. Well, I think a lot of questions have been raised.

What are you doing at the SEC now to restore consumer and investor confidence, and what improvements are needed in the way that you monitor credit rating agencies?

Ms. SCHAPIRO. There's no question but that credit rating agencies played a significant role in facilitating, I guess, in some ways the financial crisis.

The agency has engaged, as you point out, in many rulemakings, most recently the rule in 2008 which required a series of disclosures about performance statistics, the different kinds of models that were used for initial ratings versus surveillance ratings, documentation, disclosure of conflicts and so forth.

The Credit Rating Agency Reform Act, which Congress passed in 2006, specifically does not allow the agency to regulate the substance or the procedures or the methodologies of the rating agencies and something we're looking at is whether we need to ask Congress to reopen that legislation to provide greater authority.

Senator DURBIN. Who does?

Ms. SCHAPIRO. Nobody. But nonetheless, despite the limitations in the law, we are looking at doing a couple of things.

One is my perhaps my greatest concern in this area is something called ratings shopping which allows the creator of a structured product to get preliminary ratings from multiple rating agencies and then select the one they want to rate the product, presumably that being the highest rating they've gotten.

Senator DURBIN. Wish I could have had that for my report card in grade school.

Ms. SCHAPIRO. Don't we all?

Senator DURBIN. Shopping teachers.

Ms. SCHAPIRO. Exactly. If you'll give me an A, I'll take your class is what it amounts to.

So we're looking at what we can do with respect to rating shopping. Removing references potentially to ratings in the Federal securities laws and regulations which gives an air of credibility and respectability to ratings that perhaps they don't entirely deserve, looking at whether we should require different symbols for rating structured products versus rating plain vanilla corporate debt, and we're looking at more detailed disclosure about how ratings have performed over time.

So there's some things the SEC clearly can do and we are doing. We held a roundtable with rating agencies just about 1 month ago to explore some of the failures of the different business models and some of the—not the failures of the different business models but the different business models, some of the other failures that have become clear over the last year.

We're moving ahead with what we can do and we will come back to Congress if we believe at the end of the day we need more authority.

Senator DURBIN. Thank you. I'm going to ask that the subcommittee stand in recess for just a few moments and as soon as Senator Collins returns, I'm going to ask her to resume the hearing. I apologize, but it just so happens we have a rollcall vote.

The subcommittee will stand in recess.

Senator COLLINS [presiding]. The hearing will reconvene.

In Senator Durbin's absence, he's permitting me to continue the hearing. I'm certain he'll be back very soon. He's just voting.

Ms. Schapiro, last September the SEC's inspector general issued a report on its investigation of the Consolidated Supervised Entity Program, the CSE Program, through which the SEC monitored the five major investment banks.

This inspector general report found that the SEC has severely understaffed its CSE Program and thus could not effectively manage its responsibilities to monitor or question these investment banks.

As you know, I'm particularly concerned that an investment bank like BearStearns was allowed to have a leverage ratio of 30:1, truly astonishing, and yet it appears that there was not a system in place, other than a very loose voluntary system that the SEC had, to monitor these banks, and in many ways this report was truly prescient since just a few months after it was issued none of these investment banks existed anymore. They all had either failed, been acquired or merged into bank holding companies.

REGULATION OF LARGE INVESTMENT BANKS

Let me ask you a number of questions about this. First, does the SEC have the right mix of staffs to conduct the kind of oversight of a large investment bank? A lot of the SEC's employees are attorneys which is obviously very useful and helpful on the enforcement side, but does it need more auditors, more economists to have the expertise to analyze complex financial data and risk models? So the first question is the mix of expertise.

Ms. SCHAPIRO. I believe that we haven't historically had enough financial analysis experience, experience with structured products and complex derivative products.

In the last couple of months that's been an area of focus for recruitment, not just in the Enforcement Program but also in the Trading and Markets Division which has responsibility for broker-dealer risk oversight. So that even though the CSE Program is discontinued, there are still a large number of—not maybe a large number but a number of large investment banks and broker-dealers for whom the SEC still has responsibility.

That's an area that we are building and increasing our capability in in a very conscientious and sort of directed way and have been working on over the last couple of months. It's really important for us to have that capability.

Even with the presence ultimately of a systemic risk regulator, that's the result of regulatory reform, it will be important for the SEC, as the day to day regulator of over 5,000 broker-dealers, to have the capability to really understand the financial and operational status and condition of those brokerage firms.

Senator COLLINS. Second, how should—I realize these large investment banks don't exist any more but they could reappear. How should they be regulated for safety and soundness?

I cannot imagine a federally or State-chartered bank being allowed to have a leverage ratio of 30:1.

Ms. SCHAPIRO. I think the answer is they need to be regulated on a consolidated basis. So that, as you know, the securities laws are generally geared toward the protection of customer assets within the broker-dealer, but there are affiliates of the broker-dealer, there's a holding company structure, there are a lot of other entities where significant risk can be taking place, and it's important that the regulator of the entire entity have a view into what's going on in all of the related parts of the operation, so not just in the broker-dealer but also in the holding company affiliates and subsidiaries.

It is that consolidated view that will allow our regulator to make a judgment about whether leverage is excessive, capital is sufficient, the quality of management across the enterprise is up to the task.

Senator COLLINS. Another reform that we need is the ability to identify and prevent what I refer to as regulatory black holes, and the emergence of credit default swaps or other exotic and poorly disclosed derivatives certainly indicates that the current system has not been sufficient to prevent gaps in regulation of products or practices that can have consequences for the entire financial system. That's why I support having a council of regulators to look at systemic risk.

ROLE OF A SYSTEMIC RISK REGULATOR

What do you think are the advantages and disadvantages of a council approach versus vesting in the Federal Reserve the authority to be the systemic risk regulator?

Ms. SCHAPIRO. Well, I'm very much in agreement that the existing regulatory regime is riddled with holes and that there are large parts of the financial marketplace that were really not under the regulatory umbrella at all or in any meaningful way and credit default swaps is an example. Hedge funds and some other private pools of pooled funds would fall into that category, as well.

As you know, I like the concept of a council, whether it's a stand-alone council or in conjunction with a systemic risk regulator, because it brings a diversity of perspective that I think is really important to identifying where gaps may be arising, where new products may be being created in the intricacies between regulatory authorities, so that we can avoid those potentially harming the system.

And when you have a council of regulators, where you've got securities regulators, for example, which is very much focused on investor protection and transparency and bank regulators very much focused on prudential standards and safety and soundness, and insurance regulators with yet another perspective, I think you have a better chance of capturing the entire financial landscape and the potential places where those new products are arising, where those new gaps are being created.

At the same time I think there needs to be the ability, whether it's a council or a single system risk regulator or a combination, to step in and raise standards when necessary, where the functional regulator may not be aggressive enough in requiring higher capital standards or reining in leverage, that there be the ability ultimately to protect the system, to force those kind of changes.

Senator COLLINS. Thank you, Senator Tester. It's nice being temporarily chairman.

Senator TESTER. Thank you. Thank you, Senator Collins, and you're doing a fine job, I might add.

ENFORCEMENT OF THE SECURITIES LAWS

Secretary Schapiro, I'm sure you read the article yesterday in the Washington Post that dealt with enforcement actions of the SEC over the past few years. If that article's true, it is more than just a little bit distressing.

You have stated the imperative to take the handcuffs off the Enforcement Division. That article yesterday would imply to me that I don't care how much money we put at the agency, if people on top are making arbitrary decisions about how to not do their job appropriately, no amount of money is going to make it work correctly.

You're not going to do that, I know that. I've met you and long before when you were in FINRA, as you stated in your opening statement, in Montana and did a fine job education-wise and you have done a fine job in this position.

But could you just give me a little bit of insight on how this budget would help you accomplish the goal of taking the handcuffs off the Enforcement Division?

Ms. SCHAPIRO. I'd be happy to. I should say that in my 4 months at the agency, I talk a lot about enforcement. I've done some town halls with the staff. I e-mail with the staff.

I will tell you that the response has been tremendous eagerness and enthusiasm on the part of employees to get back to what we do and what we can do so well and—

Senator TESTER. Good.

Ms. SCHAPIRO [continuing]. Particularly in the enforcement context.

I think what the budget will enable us to do is have more people to bring the cases that need to be brought. We are not in danger of running out of cases. So on a very simplistic level, more people will enable us to do that.

Bringing in the right skill sets so that we're not risk averse, so that we're not afraid to tackle the most complex trading strategies or the most complex products or the most complex frauds will be important. So we need to train our people better in more sophisticated methodologies. We need to bring in the right kinds of skill sets, as well, and we need to support our people with technology.

The amount of data that comes into the agency that is unmanageable, even in the course of one major litigation, is extraordinary and we have our people wasting their times archiving e-mails and dealing with millions and millions of records when we should be able to rely almost solely on technology to do that.

We need technology to help us sort out the tips and complaints that we get, as I spoke about earlier.

Senator TESTER. The ranking member talked about potentially inadequacies of this budget. In a previous line of questions, you said you can't bring on everybody you need because it's simply impossible to manage that influx of people.

Is the budget adequate to get to where you need to go? I'm sure you have goals, either written or mental, where you want this agency to go. Is this budget adequate to get you where you need to be a year from now?

Ms. SCHAPIRO. As I said, we are genuinely grateful to the President for the increase the 2010 budget represents over 2008 and 2009. We've asked for a very significant increase in 2011 and the ability to get to that number sooner, we could handle, and I think it would make a difference in our ability to do our job.

REGULATION OF SHORT SELLING

Senator TESTER. Okay. Uptick rule. Can you discuss the Commission's effort to reinstate the Uptick rule, what's the likelihood, timing and opposition to that?

Ms. SCHAPIRO. I would be happy to do that. This is an issue of enormous, enormous public interest, and it's an issue of investor confidence, as well.

As you know, the SEC took the Uptick rule off a couple years ago after careful study and evaluation. In some ways it was a model rulemaking to eliminate it.

Nonetheless, that coincided with dramatic increases in volatility in the marketplace and investors have been clamoring for us to revisit this issue. In April, the Commission voted unanimously to seek public comment on two different approaches to short selling.

One is essentially the reinstatement of the Uptick rule as we used to know it, with some variations. The other is a short sale circuit-breaker that would be kicked into effect if the price of a stock declined by, say, 10 percent in a day, no short selling thereafter for a period of time.

We've already gotten 3,000 comment letters. The comment period closes in about 2 weeks, and then we will wade through those comment letters and hopefully bring back to the Commission a proposal for consideration.

At the same time we're looking at a couple of other issues. There's a rule, it's a temporary rule that expires in July that's had a very, very positive effect on eliminating or diminishing the fails to deliver in securities and short sales, requiring them to be closed out the next day. I expect the Commission will make that a permanent rule this summer, and we're looking at some other issues, like the potential for pre-borrow requirement.

So we are actively focused on short selling and will continue to do so.

Senator TESTER. Do you anticipate that the proposal you're going to take back to the Commission will be voted on when?

Ms. SCHAPIRO. I think we're looking at August for a vote. The comment period closes toward the end of June. With 3,000 comment letters at this point, I expect significantly more and we'll have to evaluate those, so some time this summer.

Senator TESTER. After the Commission votes on the rule, is it typically an immediate effective date?

Ms. SCHAPIRO. Generally not, if it requires technology changes at either exchanges or brokerage firms.

Senator TESTER. Would this?

Ms. SCHAPIRO. Yes, the reinstatement of the Uptick rule requires significantly more technology work than the circuit-breaker would.

Senator TESTER. Okay.

Ms. SCHAPIRO. So it could be quite dependent upon which of the two approaches.

Senator TESTER. One last and it has to do with this. Who's opposing the Uptick rule from going back into effect?

Ms. SCHAPIRO. I haven't been through the comment letters, to be honest, but I would say historically there's certain kinds of algorithmic traders, some kinds of hedge funds that are large short sellers that oppose it. There are—

Senator TESTER. That are for the most part unregulated at this point in time, right?

Ms. SCHAPIRO. That might be right.

Senator TESTER. Okay.

Ms. SCHAPIRO. There are others who believe that short selling plays a very legitimate role in the marketplace in terms of adding liquidity. It has impacts on options market-makers and others. So there is opposition to reinstatement.

I think the pure weight of the comment letters will tell us that there is much more support for doing something, whether it's the Uptick rule or the circuit-breaker.

Senator TESTER. Thank you.

FEE COLLECTIONS BY AND FUNDING OF THE SEC

Senator DURBIN [presiding]. Thank you. Chairman Schapiro, just for some perspective here, the SEC is fairly unique in that it collects a lot of money in fees and if I'm not mistaken, that number is somewhere a little north of or around \$1.4 billion, is that correct?

Ms. SCHAPIRO. The 2009 expectation is, yes, about \$1.35 billion.

Senator DURBIN. Okay. And the appropriation for your agency is around \$1 billion, a little over \$1 billion.

Ms. SCHAPIRO. Yes, 2009 \$916 billion, including the reprogramming request.

Senator DURBIN. So you are a cash generator—

Ms. SCHAPIRO. We are.

Senator DURBIN [continuing]. In terms of the revenues into the Treasury.

Ms. SCHAPIRO. And historically a very significant cash generator.

Senator DURBIN. And if the argument can be made that the industry is paying your agency to do its job and we've started this testimony here today arguing that you needed more people to do your job, it might be fair for those who are being regulated saying we're doing our part, in fact we're sending you about 40 percent more than you're actually spending in this agency.

Would that be a fair comment?

Ms. SCHAPIRO. It might be.

Senator DURBIN. Okay. Well, this concerns me because if we were going in the other direction, we'd be arguing, well, we need to come up with some revenue source here to provide the regulatory structure to make sure that the Government's doing its job, but in fact the marketplace that you regulate is creating the revenue opportunity.

Ms. SCHAPIRO. That's correct, and actually that doesn't include penalties and fines that are paid into the Treasury in those instances where we don't create a fair fund to distribute back to investors. So there's actually additional funding over the fee generation.

Senator DURBIN. Okay. Let me go to a few more specific questions.

Broker-dealers who sell stocks and bonds on commissions and investment advisors who offer advice are regulated under different Federal laws. The key difference is the rules governing their standard of conduct. Investment advisors held to a fiduciary standard which requires them to make investment decisions in the best interests of their clients. Brokers, in contrast, are held to something called a suitability standard under which they can sell securities as long as they are suitable to their clients.

Interesting little distinction there, but the variations between brokers and advisors has been blurring in recent years and it's raised concern among some regulators that customers won't be able to tell the difference.

I understand that you're taking a look at this.

Ms. SCHAPIRO. Absolutely. There's really no good reason for people not to get the same fiduciary protection and the same standard quality of regulation from people who are essentially giving them the same service but are called by different names.

Senator DURBIN. Let me ask you a question. First, let me preface it by saying I asked my staff this. I said, now is this for Chairman Schapiro or Chairman Gensler. They said, well, you better ask her. So here's a hedge fund issue for you.

The Pension Protection Act of 2006. Would this be your jurisdiction?

Ms. SCHAPIRO. The Pension Protection Act is largely administered by the Department of Labor, but there are elements that intersect with the SEC.

Senator DURBIN. Okay. Let me give you the situation. You tell me if this is something that you think falls in your jurisdiction.

This Pension Protection Act made it easier for hedge funds to take pension money without registering it as an ERISA fiduciary, meaning they don't have disclosure and other requirements of other pension plan managers. Is this your field?

Ms. SCHAPIRO. This is the Department of Labor, I believe.

Senator DURBIN. Okay. Let me stop at that point and save this for the Department of Labor then.

REGULATION OF DERIVATIVES

Derivatives, contracts between two investors, betting on whether a stock, bond or other security will go up and down in value have ballooned into one of the world's largest trading markets, estimated to be tens of trillions of dollars, yet it's largely outside the regulatory umbrella. Losses, as we know, at AIG have led to a Government bailout of \$170 billion or \$180 billion.

On May 13, President Obama unveiled a plan to regulate this market which had four stated goals.

What do you consider to be the role of the SEC in this regulation?

Ms. SCHAPIRO. This is such an important area for both the SEC and the CFTC and, as you point out, the Treasury letter of May 13 lays out some requirements that we hope will be embodied in legislation with respect to credit default swaps and other standardized over-the-counter derivatives.

It will be very important to have standardized clearing mechanisms, potentially exchange trading of standardized contracts, promote transparency, have adequate margin and collateral requirements in place for these transactions and subject the dealers in these instruments to regulation.

Exactly where the lines between the SEC and the CFTC fall, I think, are something we'll be discussing certainly over the next several weeks, but it is clearly my view, and I believe Chairman Gensler's view and the Treasury's view, that we need to work together to ensure that we bring credit default swaps and other OTC derivatives firmly under the Federal regulatory umbrella and how we exactly draw those lines will be something we'll be discussing and obviously Congress will have a deep interest in, as well.

Senator DURBIN. I'll ask a question that relates to last week it was reported that two attorneys from SEC's Enforcement Division engaged in suspicious trading in stocks of companies under SEC investigation, according to a March 3 report by the SEC Inspector General David Kotz.

Mr. Kotz concluded that the SEC previously had essentially no compliance system in place to ensure that its employees did not engage in insider trading themselves. On May 22, the SEC issued a press release outlining how the agency would increase accountability.

How will this new process impact the current SEC workload? Will it require additional resources or staff to implement?

Ms. SCHAPIRO. Thank you for asking that question. It's really an important area.

When I learned about this inspector general report in March, I immediately set in motion—and some things were already underway, I should say—a number of changes to our process which was acceptable under the Office of Government Ethics rules but clearly not sufficient in my view.

We now require all trades by employees to be pre-cleared. We've created a restricted list that prohibits an employee from trading in any stock of a company that's under investigation by the SEC, whether they know anything about the investigation or its existence or not.

We prohibit any ownership in stocks of broker-dealers, investment advisors, publicly traded exchanges, and we're requiring employees to authorize that their brokers in duplicate trade confirmation statements to the SEC where they will be incorporated into a computerized system that will make monitoring compliance with all of these new rules much more effective, and we'll be hiring a chief compliance officer. I expect we'll sign the contract for the new system in the next several days and it should be operational in 1 to 3 months.

The new rules requiring pre-clearance of all trades by the Ethics Office and the creation of the prohibited list and so forth are pend-

ing at the Office of Government Ethics and have been there for about a week. We jumped on this immediately.

Senator DURBIN. Thank you very much.

Senator COLLINS.

Senator COLLINS. Thank you, Mr. Chairman.

CONSUMER PROTECTION

Ms. Schapiro, there is an idea that is being discussed to consolidate the consumer protection functions of a variety of regulators under a single entity and one such proposal would result in the SEC losing its consumer protection responsibilities.

I personally don't think this makes any sense at all because to me, the whole reason we have an SEC is to act to protect consumer investors.

What are your views on creating a single consumer protection entity that would include the SEC's responsibilities?

Ms. SCHAPIRO. I think that it certainly is one of the ideas that's being bandied about and there are many, and I think discussions continue to be very vigorous and ongoing throughout the regulatory community about the right approach here.

I think the one thing everybody agrees on is that we must have a reorientation toward consumer and investor protection among all of our financial regulatory agencies. So whether we have the creation ultimately of a single entity or we just reheighten and refocus within the bank regulatory agencies and the SEC on the protection of the end users of financial products, we, I think, all agree that we have to go down that path.

My view is that, and it's been reported that, I don't want to create new gaps in the regulatory system and I fear that moving mutual fund regulation out of the SEC and into a new agency has the potential to do that.

Mutual fund—investor protection and the mutual fund concepts, it's about more than the end product of the sale to the investor. It's really about what's the governance of the mutual fund. What's the quality of execution that the mutual fund is getting when it's buying stocks for its portfolio? What's the quality of the disclosure of those companies that the mutual fund is buying? What's the quality of the disclosure that the mutual fund itself is making?

These are all a piece. They're all woven together to create the fabric of investor protection in the mutual fund space and so I want to be sure we don't damage that fabric.

That said, whatever Congress in its wisdom and the administration working together to create that will protect investors better and consumers better, we intend to, you know, play as strong a role as we can.

Senator COLLINS. Thank you. Mr. Chairman, I'm just going to ask one final question, if I may, and that has to do with the credit rating agencies. I understand you, too, brought this issue up, but, unfortunately, I wasn't here. I was voting when you did. So I apologize if this is redundant.

I'm very concerned about the role that was played by credit rating agencies in this crisis as far as their ratings of subprime mortgages of mortgage-backed securities.

It seems to me that the current system has so many inherent conflicts of interest built into it, not the least of which is that the credit rating agencies are being paid by the firms that are marketing the securities.

What are you looking at to improve the integrity of the credit ratings process?

Ms. SCHAPIRO. You very correctly highlight that in the issuer paid model where I create a security and then I ask you to rate it and I pay you for that rating and I pay you on an ongoing basis for future ratings, if I'm happy, has profound conflicts of interest and we are looking in particular, as we discussed earlier, at the rating shopping phenomenon which allows me to select the ratings agency that provides or promises to give the highest rating and we're also looking at more robust disclosure about fees that are paid and the conflicts of interest that exist in the issuer paid model.

We held a roundtable about 1 month ago. We brought in all different kinds of rating agencies to talk about their different business models and the pros and cons of each and we've gotten a lot of very good ideas from that process and we're hoping this summer to pursue some additional rulemaking in this area.

We will focus on rating shopping. We will focus on disclosure. We will also look at whether we need to eliminate references in SEC rules which creates a market for rating agencies and gives a certain amount of credibility and stature to ratings that perhaps they don't always deserve.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Senator Tester.

Senator TESTER. Yeah. I just do want to get to the CFTC Chairman, but I just want to just close by saying thank you. Thank you for what you've done, thank you for what you're going to do.

I would ask that, you know, as these budgets come forward, 2005 to 2007 budgets were visited about here on a couple different occasions, somebody dropped the ball. Congress probably had a part to do with it. Your predecessor may have had a part to do with it.

But it ended up in a disaster and we need to make sure that you have the resources, no more, no less, but just the resources you need to do your job, and I think that, as a friend of mine pointed out last week, we need to quit thinking in Government in silos, we need to start thinking about the consumer and whoever is consuming that product, whether it's in education or housing or in this case securities, and make sure that Government works for the betterment of everybody.

But I really want to thank you for the work you've done so far. It's very impressive, and I look forward to working with you in the future.

Ms. SCHAPIRO. Thank you very much.

Senator DURBIN. Thank you very much, Senator Tester.

Chairman Schapiro, thank you for your testimony.

Ms. SCHAPIRO. Thank you, Mr. Chairman.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. We'll be working closely with you and your agency as we put together the appropriation bill.

Ms. SCHAPIRO. Thank you.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

STAYING ON THE CUTTING EDGE OF TECHNOLOGY

Question. With rapid acceleration of electronic innovations in the securities markets, the Securities and Exchange Commission faces the challenge of keeping abreast of advancements. In the face of aggressive efforts of trading firms to invest in new technology, it is critical that SEC investigators understand the nuances of modern trading operations.

Does the SEC have sufficient resources to hire the best and brightest financial technologists?

Have you identified specific gaps in SEC's workforce expertise when it comes to electronic trading?

Answer. As you may know, the SEC has launched a new initiative with existing resources to broaden the skill sets within its workforce, ranging from financial analysis to complex trading strategies. As part of this effort, the SEC is recruiting seasoned industry professionals into our enforcement, examination, and risk assessment programs, through efforts such as the Industry and Market Fellows and the Senior Specialized Examiner programs. The SEC is also implementing enhancements to the SEC's existing training programs, in areas such as the examination program which is enhancing staff expertise in topics such as fraud detection, complex financial products, and trading and where more than a third of the staff have signed up for training to become Certified Fraud Examiners. If Congress were to approve additional resources for the SEC, then the agency would look to expand these recruiting and training efforts very significantly.

A key repository at the SEC for expertise on trading systems is the Automated Review Program within the Division of Trading and Markets. The program conducts examinations of the trading systems of markets and clearing agencies, to assess the data's confidentiality, integrity, and availability. The program has been able to stay on top of this rapidly evolving field, through efforts such as the CYBER CORPS program, which has served as a great resource for identifying talented IT professionals, and through the NSA, which has provided non-commercial software and technical training. Over the past few years, the program has increased its expertise in IT security and launched new initiatives in the areas of cyber security, auditing intermediaries in credit default swaps, and international markets. The Division now plans to implement new source code review of trading systems and more sophisticated penetration testing, to the extent resources are available.

EXPEDITING FAIR FUNDS DISBURSEMENTS

Question. Under the "Fair Funds for Investors" provision (Section 308(a) of Sarbanes-Oxley), the Securities and Exchange Commission is required to return money to investors victimized by securities fraud. Previously, disgorgements and penalties were deposited into a U.S. Treasury General Fund.

Answer. The Fair Funds provisions of the Sarbanes-Oxley Act of 2002 gave the Commission authority to increase the amount of money returned to injured investors by allowing civil penalties to be included in Fair Fund distributions. Prior to Sarbanes-Oxley, only disgorgement could be returned to investors.

Question. What improvements have been realized so far from the creation of a specialized office on "Fair Funds" disbursement?

Answer. The Commission established the Office of Collections and Distributions (OCD) to, among other things, expedite the distribution of Commission recoveries to injured investors. The Office is responsible for overseeing the distribution of funds to investors who have been injured by securities law violations, implementing the Enforcement Division's collections and distributions programs, and conducting litigation to collect disgorgement and penalties imposed in certain Enforcement actions. In addition, the Office tracks, records, and provides financial management assistance with respect to the funds and provides overall case management services for the Division.

The Office has helped streamline the distributions process and enhance its internal controls, and it has overseen the distribution of approximately \$3.2 billion to injured investors to date. Among the Office's recent initiatives has been to issue standardized, step-by-step guidance to enforcement staff on developing and imple-

menting distribution plans in both civil actions and administrative proceedings. In addition, the Office has consolidated collections and distributions information onto the enforcement program's internal website so that is more accessible to staff nationwide. In collaboration with other SEC offices, OCD has created templates to standardize the reporting of periodic and final accountings for distributions of disgorgement funds and Fair Funds, as well as to facilitate the examination of administrative expenses. In order to manage receivership expenses, the Office also developed billing instructions for receivers. OCD conducts training for the staff on the use of both the standardized reports and the billing instructions.

Question. SEC's financial tracking system (Phoenix) was established to improve management of distribution of Fair Funds to victims of securities law violations. Is the "Phoenix" system fully functional at this time? What remains to be done to improve its capabilities?

Answer. To date, the Phoenix system has only been partially deployed. Under the functionalities that are already operational, Phoenix assists with tracking and recording the disgorgement and penalties ordered in Enforcement actions. However, the Phoenix system does not yet track and record distribution information. This function is currently performed in a limited way within CATS 2000, the SEC's case tracking system, which is itself slated to be replaced.

To that end, the agency is developing business requirements for a new module that would record and monitor distribution-related information, including information reported on the newly developed standardized accounting reports. Once fully built, this module would enable the SEC to track a distribution fund's current status or phase in the distribution process, enhance reporting and internal controls over the accuracy and integrity of distribution data, and provide better information about the investment of Commission funds with the Department of the Treasury's Bureau of Public Debt. This effort also will support integration with the agency's core financial management system.

The SEC expects to finalize and deploy the distributions module in fiscal year 2010, depending on the availability of sufficient funding.

Question. I note that SEC is currently reviewing its performance measure of the percentage of Fair Funds and disgorgement dollars designated for distribution to victims within a year. What are the challenges? What is hampering SEC's ability to track the timeliness of the fund distributions and maintain accurate data?

Answer. As noted in the Commission's fiscal year 2010 budget justification, this measure is currently under review and may be adjusted in the future. One of the primary challenges with respect to such a measure has been the SEC's inadequate systems to collect, analyze, and report on distributions (described above), which have hampered the Commission's ability to track the timeliness of the fund distributions and maintain accurate data.

Question. What portion of this year's budget (fiscal year 2009) and the proposed needs for fiscal year 2010 will be devoted to the Fair Funds distribution project?

Answer. The first major expense associated with Fair Funds distributions is information technology, most notably the Phoenix system. In fiscal year 2009, the SEC expects to obligate approximately \$0.1 million in ongoing maintenance and support related to Phoenix. For fiscal year 2010, the agency estimates that distributions-related projects will cost approximately \$3.2 million. These projects include efforts to develop new collections and distributions tracking functionalities, enhance the current Phoenix system, integrate Phoenix with the enforcement program's new HUB tracking system and the core financial system, and conduct ongoing system maintenance.

A second component of the SEC's distributions-related costs is the expense associated with the Office of Collections and Distributions. OCD's costs amount to approximately \$6.0 million in fiscal year 2009 and \$6.2 million in fiscal year 2010. However, it is important to note that the Office performs a variety of functions in addition to distributions, including assisting with collection of delinquent debts and maintenance of internal controls.

The final element is the substantial staff time spent on distributions functions within other parts of the SEC. For example, within the enforcement program (outside of OCD), attorneys spend considerable time on the development, oversight, and implementation of distribution plan actions, while support staff perform data input for all cases. In addition, the SEC's Office of Financial Management aids with funds investment and disbursement, as well as internal controls; the Office of the General Counsel reviews and comments on distribution-related documents; and the Office of Economic Analysis evaluates the methodologies for measuring investor loss. Although the staff time involved is significant, the SEC does not currently track costs at this level.

QUESTION SUBMITTED BY SENATOR BEN NELSON

RULE 151A, ISSUED JANUARY 16, 2009

Question. On January 16th of this year, the Commission issued a new rule regarding indexed annuities and certain other insurance contracts. This rule takes effect on January 12, 2011.

What level of resources will the SEC devote in fiscal year 2010 to preparing to implement this rule? Can you calculate the cost to the Commission of the work necessary to fully implement this rule so that it can be operational on January 12, 2011?

Looking ahead to the next fiscal year (fiscal year 2011), in taking on this additional regulatory responsibility, will additional staff be required? What will additional staff needs and additional regulatory responsibility mean for the Commission's budget?

Answer. The release adopting this rule (Rule 151A) articulated the Commission's determination that investors in certain indexed annuity contracts are entitled to the protections of the federal securities laws. The rule includes a new definition of "annuity contract" that, on a prospective basis, will define a class of indexed annuities that are outside the scope of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities will, on a prospective basis, be required to register under the Securities Act. With few exceptions, indexed annuities historically have not been registered as securities. The new definition will apply to indexed annuities that are issued on or after the January 12, 2011, the effective date of the rule.

The staff is currently considering how to tailor disclosure requirements for indexed annuities. As with any other rulemaking, if the staff determines to recommend that the Commission propose new disclosure requirements, resources will be applied to develop a proposal, analyze public comments on the proposal, determine whether to recommend adoption of the proposal and consider whether and how it should be modified to reflect commenters' concerns.

In addition, the Commission encouraged insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance regarding the implementation of the rule. We anticipate that any responses to such requests will require staff resources.

The Division of Investment Management also anticipates reviewing filings for approximately 400 new indexed annuity contracts in the first year.

In all, the Division of Investment Management believes the implementation of Rule 151A will require an allocation of seven staff positions during the first year, with that number likely to decrease in the years following the initial implementation. The estimated cost of these seven positions is \$1.6 million for fiscal year 2011. As discussed above, these staff will perform further rulemaking as appropriate, provide interpretive advice, and review disclosure filings.

QUESTIONS SUBMITTED BY SENATOR SUSAN COLLINS

Question. Chairman Schapiro, recently many news outlets have issued stories about the administration's proposal to move some consumer-protection powers outside of the SEC. Reports state that you are opposed to such a proposal. A May 20th Wall Street Journal article quotes you as saying that such a plan would "... be hugely expensive and highly inefficient" Would you discuss your objections?

Answer. I did not believe that investors would be better protected by separating some securities products from others, potentially creating gaps in the regulatory and enforcement regime. Securities products are different from consumer credit products: generally they are not guaranteed and include a number of inherent risks, including the loss of principal. The administration's white paper outlining its consumer protection plan appears to recognize this, and I do not object to that approach.

Question. Secretary Geithner recently laid out a framework for overseeing the derivatives market including rigorous reporting requirements. Such a proposal would give the SEC and CFTC new authorities to regulate derivatives. What are your thoughts on the plan and the role of the SEC in the regulation of derivatives?

Answer. I agree with the Secretary's approach. Both the SEC and CFTC have a role in regulating derivatives products. We continue to work together and make progress on how such a regime might work to best fill gaps in the regulatory framework and prevent regulatory arbitrage. I look forward to working with Congress to make the necessary legislative changes.

Question. Two veteran enforcement lawyers at the SEC are currently under investigation for insider trading. A May 16 Wall Street Journal article quotes a report by the SEC Inspector General saying that “the SEC has ‘essentially no compliance system’ to detect potential insider trading.” As a result of the investigation into the trading activities of the two attorneys, the SEC has proposed the imposition of new rules on employee trades. How does this investigation affect your confidence in the ability of the SEC staff? In your estimation, do the recent troubles at the SEC signify fundamental problems within the organization, and if so how do you propose to rectify the issues?

Answer. I have the utmost confidence in the ability of the SEC’s staff and their unflagging dedication to the protection of investors. Time and time again, I have been impressed by the staff’s talent, integrity, and enthusiasm for the agency’s mission. However, it became clear to me soon after joining the agency that the SEC’s system for ensuring compliance with employee trading rules was not sufficient. The report by the agency’s Inspector General concerning trading activity by certain employees reinforced my belief that the SEC should have a trading compliance system that is second to none.

I know the agency’s staff shares my belief that, in light of the SEC’s mission, it is vital that we conduct ourselves according to the highest standards of ethical conduct when it comes to our own financial holdings and transactions. To that end, we have taken several significant steps to strengthen the SEC’s compliance system and reduce the potential for even the appearance of inappropriate securities trading:

- We have proposed new rules concerning employee trading. These rules will, among other things:
 - Require the pre-clearance of all trades.
 - Prohibit all trading in the securities of a company under SEC investigation, regardless of whether the employee is aware of the investigation.
 - Require all employees to authorize their brokers to provide duplicate trade confirmation statements to the agency.
 - Prohibit the ownership of securities in publicly-traded exchanges and transfer agents, in addition to existing prohibitions against owning securities in other firms directly regulated by the Commission.
 - Require employees to certify that they do not have any non-public information about the company whose securities they are trading.
- These rules were submitted to the Office of Government Ethics (“OGE”) on May 22, 2009, and we await OGE’s comments.
- We recently retained an outside firm specializing in automated compliance systems to develop a new computer compliance system for the agency, which will automate and simplify the transaction reporting process and make it easier to verify and monitor employee trading.
- We are creating a new Chief Compliance Officer position, and have already received applications from a number of excellent candidates for the new position.
- I have consolidated responsibility for the oversight of employee securities transactions within the SEC’s Ethics Office and devoted additional staff resources to monitor, review, and spot-check these transactions.

These measures will bolster and modernize the agency’s compliance program, and help the talented and committed staff do its critical work of protecting investors without distraction.

Question. The fiscal year 2010 budget request does not include an increase for the SEC Inspector General. Considering the likelihood of an increased workload at the IG’s office, as the SEC increases surveillance and monitoring of employee trading, do you think that the IG will need additional funds?

Answer. The Inspector General submitted a request for three additional positions only a few days before the publication of the SEC’s Congressional Justification for fiscal year 2010, and therefore these additional positions were not reflected in the document. However, I have since approved the addition of these personnel, which would bring the OIG to a total of 19 positions. When these new staff are combined with the two positions approved for OIG in January 2009, the Office will have grown by a total of 73 percent within this calendar year, which is the highest growth rates of any SEC office during this timeframe.

Question. Please provide a breakdown of the tips and complaints the SEC received in fiscal year 2007 and fiscal year 2008, to help explain the large decline in that year.

Answer. As you mentioned, the number of tips and complaints received by the SEC’s Office of Internet Enforcement declined significantly between 2007 and 2008, from about 1,586,000 to about 615,000 in 2008. Unfortunately, the SEC has not had a tracking system that can break down those figures into their component parts or support rigorous analysis of underlying trends.

The SEC's initiative to bolster its systems for tracking tips and complaints, working with the Center for Enterprise Modernization, will help the agency perform much better analyses in the future. Such analyses will help the SEC understand the overall statistics on tips and complaints and identify trends among specific firms or practices that can provide valuable information for potential enforcement action and compliance exams. The SEC also is working to streamline and standardize the agency's handling of tips and complaints, so they can be addressed more consistently and effectively. Nevertheless, for the 2007–2008 period, the SEC is reliant on anecdotal evidence to explain the decline in tips and complaints during that timeframe.

In general, the number of complaints the agency sees is related to the volume of spam and commercial email traffic received by investors. A number of factors likely affected this volume during the 2007–2008 timeframe. First, the SEC's initiative starting in 2007 to combat spam-driven stock manipulations was reported to have been a major contributor to reducing the amount of spam.¹ Under this initiative, the SEC suspended trading in the securities of dozens of companies that had been the subject of spam stock promotions and initiated several spam-related enforcement actions. According to a private-sector Internet security report, a 30 percent decrease in stock market spam "was triggered by actions taken by the U.S. Securities and Exchange Commission, which limited the profitability of this type of spam . . ."²

Another major factor is the growing use and sophistication of commercial-grade spam email filters, blacklists, and experimental "data mines," which radically diminish the number of mass investment solicitations received by the average investor. Additionally, tough state and federal anti-spam laws, and high-profile prosecutions under those laws, likely helped to deter spammers.³

General market conditions also likely played a role in the decline in tips and complaints. Email stock promoters' activities lend themselves best to the promotion of obscure, thinly-traded stocks, such as the tech stocks that flourished during the late 1990s market "bubble." Since the collapse of that bubble, it seems fewer investors have been interested in these microcap stock promotions.

It is important to note that, while the number of tips and complaints went down significantly in 2008, the figure is still 146 percent higher than it was 5 years previously. By comparison, the number of full-time equivalents in the SEC's enforcement program increased by only 23 percent during that period. Also, while the quantity of complaints the SEC received decreased between 2007 and 2008, the SEC believes that the quality of complaints has increased dramatically. Thus, the agency's workload from these complaints has actually become greater over the past year, despite the reduced number of complaints relating to spam.

ADDITIONAL SUBMITTED STATEMENT

[CLERK'S NOTE.—The subcommittee has received a statement from the Investment Company Institute which will be inserted into the record at this point.]

¹"SEC makes inroads against financial spam; Crackdown pays off as e-mail campaigns slow," by Matt Krantz, USA Today, Oct. 5, 2007 at p. 7A.

²http://eval.symantec.com/mktginfo/enterprise/white_papers/enterprise-whitepaper_internet_security_threat_report_xii_09_2007.en-us.pdf. Copyright 2007 Symantec Corporation. All rights reserved. Symantec, the Symantec Logo, BugTraq, Symantec Brightmail AntiSpam, and Symantec DeepSight are trademarks or registered trademarks of Symantec Corporation or its affiliates in the United States and other countries. Apple, Mac OS, and QuickTime are trademarks of Apple Inc., registered in the United States and other countries. Safari is a trademark of Apple Inc. Microsoft, ActiveX, Windows, and Windows Media are either registered trademarks or trademarks of Microsoft Corporation in the United States and/or other countries. Sun, Java, and Solaris are trademarks or registered trademarks of Sun Microsystems, Inc. in the United States and other countries.

³See http://www.msnbc.msn.com/id/18955115/arrest_of_Robert_Alan_Soloway/; <http://www.sophos.com/pressoffice/news/articles/2008/02/japan-spam.html> (Yuki Shiina); http://spamkings.oreilly.com/archives/2006/03/stock_spammers_stung_by_secret.html ("g00dfellas" spam gang).

PREPARED STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute¹ appreciates this opportunity to submit testimony to the Subcommittee in support of the administration's fiscal year 2010 appropriations request for the Securities and Exchange Commission (SEC). We commend the subcommittee for its consistent past efforts to assure adequate resources for the SEC. For the reasons expressed below, we urge Congress to provide appropriations at least at the funding level requested by the President.

As SEC Chairman Mary Schapiro noted in her testimony, the recent financial crisis has served as a reminder of the importance and interconnectedness of the securities markets to our nation's economy and the financial health of millions of Americans. The crisis also demonstrated that the current regulatory system is not up to the challenges posed by modern financial markets and needs to be significantly strengthened and modernized. It has led to broad support for reform of the U.S. system of financial services regulation, including numerous calls for Congress to close regulatory and disclosure gaps to ensure appropriate oversight with regard to hedge funds, derivatives, and municipal securities. Toward these ends, it is critically important to provide the SEC with the resources necessary to assure its ability to soundly and effectively regulate securities offerings, market participants, and the markets themselves. And, to the extent that the scope of the agency's responsibilities is expanded with respect to hedge funds, derivatives, and/or municipal securities, it will be imperative that it have sufficient staffing and resources to effectively perform all of its oversight functions.

More generally, the ongoing policy discussions about regulatory reform have highlighted why adequate funding for the SEC should continue to be a Congressional priority. Unlike other financial regulators, the SEC is specifically charged with protecting investors. The agency seeks to fulfill this mission in many different ways, including through the disclosure and substantive rules it adopts and administers, through examinations of regulated entities, and through its enforcement program, to name a few. In the wake of the financial crisis, it is essential to provide the SEC with the resources it needs to successfully pursue its investor protection mission.

Mutual funds and other registered investment companies have a strong stake and vested interest in having a well-funded and effective SEC. Registered investment companies are an integral part of our economy. They represent, as a whole, the largest group of investors in U.S. companies, holding 27 percent of the outstanding stock in U.S. companies at year-end 2008. Registered investment companies also held the largest share of U.S. commercial paper—an important source of short-term funding for major U.S. and foreign corporations. In addition, they continue to be one of America's primary savings and investment vehicles for middle-income Americans. Today, over 93 million investors in more than 53 million U.S. households own shares of registered investment companies; the median household income of these investors is \$80,000. And, since 1990, the percentage of U.S. retirement assets held in mutual funds and other registered investment companies has more than quadrupled. These millions of Americans continue to recognize that mutual funds are the best means of achieving their long-term financial goals. They deserve and benefit from continued vigilant regulatory oversight of mutual funds and other registered investment companies.

The administration's fiscal year 2010 budget proposes SEC funding at a level that represents a 7 percent increase over fiscal year 2009. Chairman Schapiro explained in her testimony that this would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance its ability to uncover and prosecute fraud, and allow it to begin to build desperately needed technology. More specifically, Chairman Schapiro stated that the additional funding would allow the SEC to hire seasoned industry professionals and market experts to strengthen and expand the SEC's Office of Risk Assessment, improve its examination program, and bolster its oversight of the investment management and broker-dealer industries. We have strongly supported precisely these types of measures.² It is essential that the agency

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$10.18 trillion and serve over 93 million shareholders.

² See Letter to The Hon. Mary L. Schapiro from Paul Schott Stevens dated February 18, 2009 (attaching recommendations for SEC priorities under Chairman Schapiro's leadership). See also *Financial Services Regulatory Reform: Discussion and Recommendations*, which is available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf. Chairman Schapiro also noted in her testimony that she intends to improve the overall management of the SEC, including by hiring a Chief

have greater ability (and resources) to attract and retain professional staff having significant prior industry experience. Their practical perspectives would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy. The new Industry and Market Fellows Program is an encouraging step in the right direction, but we also believe that the agency should build strong economic research and analytical capabilities and should consider having economists resident in each division.

We are particularly pleased that a key strategic priority for the SEC's Division of Investment Management will be to strengthen and improve the money market fund regulatory regime. Last November, we convened a high level industry working group to study the money markets. In March, the group made a series of comprehensive recommendations that responded directly to weaknesses in current money market fund regulation, identified additional reforms that will improve the safety and oversight of money market funds and position responsible government agencies to oversee the orderly functioning of the money market more effectively.³ We look forward to working with the SEC on this critically important issue.

In conclusion, the SEC and the fund industry share a common objective of assuring that mutual funds remain a vibrant, competitive and cost effective way for average Americans to access the securities markets and realize their long-term financial goals. Future regulatory and oversight actions by the SEC will play a key part in this process. It is therefore critically important that the SEC have sufficient resources to adequately fund the staffing of the agency and to take other steps to fulfill its mission of protecting the nation's investors, including the over 93 million Americans who own mutual funds. Accordingly, we urge Congress to provide appropriations at least at the funding level requested by the President.

We appreciate your consideration of our views.

Operating Officer to manage the organization. We also supported this idea in both our February 18, 2009 letter to Chairman Schapiro and *Financial Services Regulatory Reform* white paper.

³ See *Report of the Money Market Working Group*, submitted to the Board of Governors of the Investment Company Institute on March 17, 2009, available at http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. GARY GENSLER, CHAIRMAN

Senator DURBIN. I'd like to invite Chairman Gensler from the Commodity Futures Trading Commission to come forward.

This year, 2009, marks the 35th year since the establishment of this agency. At this time of its inception in 1974, CFTC's 500 employees were tasked with ensuring fair practices and honest dealings on the commodity exchanges of America's then \$500 billion industry in 1974.

Today, it is a \$22 trillion industry and it looks a lot different. The traditional agricultural products are still there, but the landscape has been diversified with novel and complex commodities, from grains to gold, currencies to carbon credits.

In the past decade trading volume has increased more than tenfold, reaching over 3.4 billion trades in 2008. Actively traded contracts have quintupled from 286 in 1998 to 1,521 in 2008.

CFTC oversees \$5 trillion of trades every single day. So we don't want you to stay at the table too long. We want you to get back and keep an eye on those trades, but we invite you, Chairman Gensler, to give your testimony at this point.

Mr. GENSLER. Thank you, Chairman Durbin, Ranking Member Collins, and members of the subcommittee, Senator Tester.

I'm pleased to be here today to discuss our budget and especially pleased to learn that Senator Durbin recently visited our Chicago office which very encouraged the staff and I thank you for it.

I'm also grateful to each of you for your individual support on my recent confirmation. It's an honor to serve the country in this capacity.

I come before you having served as Chairman just 6 calendar days, but with full knowledge of the failures of our regulatory system, failures that affected all Americans, failures that we must ensure do not happen again, and as Chairman, I will use every authority available to protect the American people from fraud, manipulation, and excessive speculation.

I will also work with Congress on new authorities to bring much-needed transparency and regulation to the over-the-counter derivatives marketplace.

I am grateful on behalf of the agency for the \$146 million recently appropriated for this Commission. This boost has allowed us to get back to beginning to address the alarmingly low staffing levels there are at the agency. Our size, however, is still roughly equivalent to the Commission that was established 35 years ago.

Today, the futures market is dramatically different, as Chairman Durbin just outlined, being some 45 times larger than it was 35 years ago, and much more complex as well.

Just 10 years ago the CFTC was near its peak staffing levels, near 580 full-time equivalents. It's shrunk over 20 percent in the

past years, but with your help the fiscal 2009 funding will permit us to get back to where we were in 1999.

Since 1999, however, volumes have gone up fivefold, the number of contracts have gone up sixfold. The complexity, of course, I don't need to tell you, has gone up dramatically. We've gone from open outcry pits to electronic trading which is in some cases harder to monitor. We've also lived through the worst financial crisis in 80 years and seen the results of an asset bubble in commodity prices.

In short, the Commission remains an underfunded agency and we're very grateful to the President's budget of \$160.6 million in recognition of some of these needs. If I could just share with you some of the things that have been highlighted to me in my first 6 days. I think we still need to ensure that our enforcement effort is larger to ensure robust enforcement of our laws. Currently, we have about 141 attorneys in our Enforcement Division. I believe this is still quite lower than what's required, given the financial turmoil we've lived through.

We must ensure greater transparency. I believe that commodity index funds did contribute to the asset bubble that we've just lived through. To bring greater transparency will require more economists. It's going to require announcements in our weekly commitments in traders' reports. We'll also need to upgrade our systems as well.

We must ensure that position limits consistently applying across the board, and that we're reviewing hedge exemptions and no action processes in that regard.

Our information technology (IT) systems and particularly our mission critical systems on positions and transactions have not been upgraded for quite some time and I've looked forward to working with this subcommittee on getting funds to try to upgrade these mission critical systems.

And also, we need to ensure timely review of new products and rule change filings. This has lagged a great deal and just last year with the new farm bill, the review of significant price discovery contracts will be important moving forward.

These are only a few of the funding priorities, but I wanted to give the subcommittee a tangible sense of some of the things that we're grappling with and struggling with.

With that in context, the \$14.6 million of additional funding, about one-half of that is to stay at current services and one-half of that in the President's budget, fortunately, is for 38 new full-time equivalents to bring us back just above where we were 10 years ago, to about 610 full-time equivalents. These positions are essential. The increase, however, still won't allow us to fully address these complex markets and what we need to do.

Before I close, I would like to highlight that the additional funding needs will also accompany much-needed regulatory reform. I, along with other regulators, and the administration feel we need to broaden reforms in the over-the-counter derivatives marketplace and bring it all under the regulatory umbrella. I look forward to working with this subcommittee and Congress for funding those new authorities to make sure they're properly implemented.

PREPARED STATEMENT

And with that, I thank you very much and I look forward to answering your questions.

I hope my written testimony can be entered into the record.

Senator DURBIN. Of course. It will be.

[The statement follows:]

PREPARED STATEMENT OF GARY GENSLER

Thank you, Chairman Durbin, Ranking Member Collins, and other members of the Subcommittee. I am pleased to be here to testify on behalf of the Commodity Futures Trading Commission, and I appreciate the opportunity to discuss issues related to the Commission's 2010 Budget. I am also grateful to have had each of your individual support for my recent confirmation. It is a great honor to serve my country in this capacity.

I come before you today having only served as CFTC Chairman for 6 calendar days, but with the full knowledge of the failures of our financial regulatory system; failures that affected all Americans and failures that we must ensure never occur again.

The last decade, and particularly the last 21 months, has taught us much about the new realities of our financial markets. We have learned the limits of foresight and the need for candor about the risks we face. We have learned that transparency and accountability are essential and that only through strong, intelligent regulation can we fully protect the American people and keep our economy strong.

As Chairman of the CFTC, I will use every tool and authority available to protect the American people from fraud, manipulation and excessive speculation. I also look forward to working with Congress to establish new authorities to close the gaps in our laws and bring much-needed transparency and regulation to the over-the-counter derivatives market. I firmly believe that doing so will strengthen market integrity, lower risks, protect investors, promote transparency and begin to repair shattered confidence in our financial markets.

I would like to thank the Committee for the \$146 million recently appropriated for the CFTC for the 2009 fiscal year and special thanks to Chairman Durbin for visiting our Chicago office last year. As a result of this much needed boost in funding, the Commission has begun to address our alarming staffing levels; levels that recently reached historic lows.

At present, the Commission employs about 500 career staff—roughly equivalent to when the Commission was created in 1975. Three decades later, the futures market has changed in every way: with respect to volume, complexity, risk and locality. What was once a group of regional domestic markets trading a few hours 5 days a week is now a global market trading 24/7, and what was once just a \$500 billion business has exploded to a \$22 trillion annual industry.

Ten years ago, the CFTC was near its peak staffing level at 567 employees, but shrunk by 20 percent over the subsequent 8 years before hitting a historic low of 437.

With the increase in fiscal year 2009 funding the CFTC can reach 572 employees.

While this is a start, I believe that merely raising our staffing levels to the same as a decade ago will not be enough to adequately fulfill all of the agency's missions. In the last 10 years, trading volume went up over five fold. The number of actively traded futures and options contracts went up over six fold, and many of these are considerably more complex in nature. We also moved from an environment with open-outcry pit trading to highly sophisticated electronic markets.

In addition to the dramatic evolution of the futures industry, we have experienced the worst financial crisis in 80 years. We also experienced, in my view, an asset bubble in commodity prices. The staff of the CFTC is a talented and dedicated group of public servants, but the significant increase in trade volume and market complexity, as well as rapid globalization, commands additional resources to effectively protect American taxpayers.

For all of these reasons, I feel it is appropriate for our staffing levels and our technology to be further bolstered to more closely match the new financial realities of the day.

In short, despite the recent increase in funding, the Commission remains an underfunded agency. The President's Budget recommendation of \$160.6 million is recognition of this need. Specifically, the Commission needs more resources to hire and retain professional staff and develop and maintain technological capabilities as sophisticated as the markets we regulate.

I'd like to identify some of my priorities and provide some illustrations of how resource limitations have constrained the Commission. Among my priorities will be to:

- Ensure robust enforcement of our laws. Currently, the Commission's enforcement program consists of 122 employees—the lowest level since 1984. Though fiscal year 2009 funding will get us back to 141 enforcement employees, this is still below the agency's peak of 167 and well below what we need given the current financial turmoil. Any financial downturn reveals schemes that could only stay afloat during periods of rising asset values. Our current, and much larger, downturn is exposing more leads than the Commission can thoroughly and effectively investigate. This is true both as it relates to fraud and Ponzi schemes as well as staff intensive manipulation investigations. The regulations we enact to protect the American people are meaningless if we do not have the resources to enforce them;
- Ensure greater transparency of the marketplace. Also, I believe that commodity index funds and other financial investors participated in the commodity asset bubble. Notably, though, no reliable data about the size or effect of these influential investor groups has been readily accessible to market participants. The CFTC could promote greater transparency and market integrity by providing further breakdowns of non-commercial open interests on weekly "Commitments of Traders" reports. The American public deserves a better depiction of the marketplace. The temporary relief from higher prices does not negate this need, especially given that a rebounding of the overall economy could lead to higher commodity prices;
- Ensure position limits are consistently applied. The CFTC has begun a review of all outstanding hedge exemptions to position limits. This review will consider the appropriateness of these exemptions and look for ways to institute regular review and increased reporting by exemption-holders. The Commission also has begun a review of the process and standards through which no-action letters are issued. As part of these reviews, CFTC staff will consider the extent to which swap dealers should continue to be granted exemptions from position limits;
- Ensure the Commission has the tools to fully monitor the markets. We must upgrade the Commission's mission critical IT systems for the surveillance of positions and trading practices. Neither is robust enough nor have they been upgraded to reflect the vast increase in volume and complexity. Our systems must begin to produce the surveillance reports needed to meet the analytical needs of our professional staff and the transparency needs of the public; and finally
- Ensure timely reviews of the many new products and rule change filings of the futures markets. These have lagged due to the growth and complexity of markets and the added responsibilities extended to the Commission in the 2008 Farm Bill. The Farm Bill requires staff to review all contracts listed on Exempt Commercial Markets (ECMs) to determine if they are significant price discovery contracts—if they are, then any ECM that lists such a contract must also be reviewed to determine compliance with a stringent set of core principles under the Commodity Exchange Act.

Other examples that I believe are illustrative of the difficult tradeoffs caused by resource constraints are:

- The Commission does not conduct annual compliance audits of every Designated Contract Market (DCM)—rather only periodic reviews on average, every 3 years;
- The Commission does not conduct annual compliance audits of every Derivatives Clearing Organization (DCO)—rather periodic reviews are conducted of selected core principles that are rotated and completed every 3 years; and
- The Commission does not conduct routine examinations of Commodity Pool Operators, Commodity Trade Advisors, and Futures Commission Merchants—a function currently performed by Self Regulatory Organizations. If the Commission were to perform direct periodic audits our staff would better understand the operations of brokers and managed funds and could better assess compliance with the law and regulations.

These are only a few of our important funding priorities and the workload challenges imposed by resource limitations. There are, of course, others. I hope that this helps the Committee to understand, in a tangible way, the challenges the Commission faces in regulating the futures markets the way the Nation requires.

Although the work of the Commission can be highly technical in nature, the mission of the agency is quite straightforward. The CFTC is charged with:

- Protecting the public and market users from manipulation, fraud, and abusive practices and
- Promoting open, competitive and financially sound futures markets.

With that context, I would like to address the specifics of the fiscal year 2010 Budget request. The fiscal year 2010 Budget proposes an increase of \$14.6 million. Approximately half of the increase is needed to maintain our fiscal year 2009 level of operations into fiscal year 2010. The balance would fund an additional 38 positions.

Twenty-six of the 38 staff would be allocated to principal program areas. Specifically, we would allocate 11 positions to Enforcement, 8 to Market Oversight, 6 to Clearing and Intermediary Oversight, and 1 to the Chief Economist's office. The remaining 12 positions will provide critical mission support in the areas of legal analysis and counsel, technology support, international coordination, legislative and public outreach, and human capital and management support.

The additional 38 positions are essential to addressing some of the limitations I mentioned earlier. This increase, however, will not provide the Commission with the critical mass of professional and technical expertise needed to ensure that the growing markets remain free of manipulation and fraud.

For example, our enforcement staff needs to be significantly expanded to:

- Ensure that crimes are punished to the fullest extent of the law;
- Develop strategies aimed at quickly identifying and eradicating fraudulent schemes, such as Ponzi and foreign exchange “boiler rooms”; and
- Importantly, pursue resource-intensive investigations and litigations involving manipulation, including energy-related market abuses, so wrongdoers will not believe they are immune from enforcement simply due to the complexity of an enforcement action.

Insufficient resources in the enforcement division force it to be too selective in the matters it investigates.

Our market oversight operation needs additional highly-skilled economists, investigators, attorneys and statisticians to:

- Analyze trading reports quickly and thoroughly, identify potential market problems or trader violations promptly, and avoid market disruptions and pricing anomalies;
- Conduct timely and complete reviews of regulated entities to ensure compliance with all core principles;
- Examine exchange self-regulatory programs on an on-going and routine basis with regard to trade practice and market surveillance; and
- Ensure their compliance with disciplinary, audit trail, record-keeping and governance obligations.

Our clearing and intermediary oversight program needs additional auditors, analysts, and attorneys. This would allow us to:

- Ensure clearing systems protect against a single market becoming a systemic crisis;
- Protect investors' funds from being misused or exposed to inappropriate risks of loss; and
- Guard against abusive sales practices that harm customers and undermine market integrity.

Our economic research program needs more economists to review and analyze new market structures and off-exchange derivative instruments, especially in light of novel and complex products and practices that call for state-of-the-art economic analysis. Further, additional resources would enhance our economic and statistical analysis, improving transparency of markets and better supporting the Commission's enforcement and surveillance programs.

We also need to transform the current legacy information technology systems into robust systems capable of efficiently receiving and managing massive amounts of raw data as well as transforming them into useful analytical and research tools.

The Commission has made a substantial investment in technology over the past 2 years—focusing first on upgrading obsolete computer hardware to industry standards. We need technology, however, that is as modern and dynamic as the technology-driven markets we are charged with overseeing. Our investment in technology must be more than just periodic equipment upgrades and maintenance. The Commission must leverage resources by employing 21st century technology to protect the American people.

As the Commission informed this Committee in February of this year, the agency believes it needs \$177.7 million for fiscal year 2010 to perform its present duties. I look forward to working with this Committee to secure the funding necessary to meet our current regulatory responsibilities.

Before I close, I would like to briefly highlight funding needs that might go along with much needed regulatory reform. The CFTC along with the administration and other financial regulators is committed to working with Congress on broad regu-

latory reform. This is particularly true for the markets that the CFTC currently regulates and the markets that may soon come under our regulation.

Specifically, we must urgently regulate the over-the-counter derivatives market and address excessive speculation through aggregated position limits.

President Obama has called for action by the end of this year to strengthen market integrity, lower risks, and protect investors. The future of the economy and the welfare of the American people depend on a vibrant Commission to assist in leading the regulatory reform ahead. Additional funding will be necessary to properly implement these reforms.

I look forward to working with the Members here today and others in Congress to accomplish this goal.

Thank you very much. I would be happy answer any questions you may have.

STAFFING

Senator DURBIN. Chairman Gensler, thank you for being here and we're glad that you're on the job, and it strikes me that if we look at your recent arrival and the recent arrival of a lot of money into your agency, that you're really going to be tested quickly in terms of whether or not you can gather together the professional staff to do your job and the added responsibilities that you mentioned in the farm bill. I don't know if you have had a chance to look at the inspector general's report on your agency but that was, I think, one of the major points made by that report, as to whether or not you would have the human capital necessary to monitor the complex situations that you face.

Now, there's been some problems in the past at CFTC when it comes to Federal pay parity, where the Government basically said let's start treating all the professionals in our agencies alike and CFTC seemed to be lagging in the past in bringing the income levels up to meet the pay parity standard.

You mentioned my visit to the office in Chicago and I'm glad I did it. I don't know how many other Congressmen or Senators have been there, but it's an eye-opener. It's a small staff but it's an amazing staff and I was very impressed. There are some people we have working for our Government in that office who do such exceptional work.

One man they introduced me to, I've forgotten his name unfortunately, and they told me what his responsibility was each day and they said he is the go-to guy. He watches all of these transactions going and he's the one who monitors them and if he weren't here, you know, I'm not sure how good a job we'd do. It would take a lot more people to try to do what he does every day. I said, "Does this man take a vacation?" They said, "Yes, he does and we try to hang on until he gets back."

It's that kind of person and that kind of responsibility which leads me to ask, now that we've sent you a substantial amount of money in this year's fiscal year bill, in the omnibus bill, and now that we've told you you need more professional people and now that you're looking at this pay parity issue, how are you trying to fit these pieces together into some coherent way of expanding your agency in a manner that is consistent with rewarding the good performance of people there and bringing onboard the kind of folks that you need to meet these new electronic markets?

Mr. GENSLER. Senator, I think you're right in these are important challenges. Just being in the job for 6 days, what I see are talented staff facing significant challenges ahead.

Senator DURBIN. Incidentally, you're new to this, but it's always great to start your answer with Senator, you're right. Please proceed.

Mr. GENSLER. Senator, you're right. As I understand it, the agency's been able to fulfill all of the job postings—about 95 job postings. There's confidence, at least within the staff, as to what might be achieved by September 30. We all know there's a summer and August and so forth, but all the postings are up. Some of the recruiting has already occurred and people have been coming in.

But I also agree with Chairman Durbin that this agency, which was so sorely underfunded and actually shrank over 20 percent in the face of this complexity during the last 8 years, has too many jobs that are being done by one person or not enough. As an example, when I asked, well, how large is the group that oversees clearing, this really important function in futures. I was told that there is a nine-person staff out in Chicago, which is part of that larger staff, I said, "Is that enough?" Well, you know, everybody said, "Well, that's what we have. We've had to make tough choices."

So I think that's very important. I'm committed to make sure that taxpayer dollars are put to work most appropriately and efficiently, but I do have confidence in what I've seen in 6 days, that there's a plan of action for these hires.

Senator DURBIN. What about the pay parity issue?

Mr. GENSLER. On pay parity, as I understand it, we've been able to bring up to a figure of about \$4 to \$4.5 million.

Senator DURBIN. I might say that there—

Mr. GENSLER. I'm sorry Senator, let me just correct this. There is \$1.4 million in the fiscal 2010 budget specifically with regard to that.

STUDENT LOAN REPAYMENT

Senator DURBIN. One obscure little thing which I accomplished when Senator Collins was chairing the Governmental Affairs Committee.

Senator COLLINS. Governmental Affairs.

Senator DURBIN. Governmental Affairs Committee, when it started, was the whole question of student loan repayment as an incentive to bring in professionals to Federal agencies.

The SEC is one of the best agencies in Government on this front, 385 of their staff, 181 of whom are attorneys have used the student loan repayment, and I believe this brings them into Federal Government where their services are very valuable. Otherwise they might not be able to consider it.

CFTC has not instituted such a program, probably for lack of money, and I'm wondering if you expect to be able to provide that benefit as part of recruitment in the future.

Mr. GENSLER. The answer is yes, sir, I think that we tried to do—I think it was just a small amount this year, \$200,000 in this fiscal year.

Senator DURBIN. I see.

Mr. GENSLER. In fiscal 2009, actually.

Senator DURBIN. Well, I think it can be a major part of attracting really talented college graduates who otherwise would be lured to something that may pay a little more just to defray their costs.

Mr. GENSLER. The agency shares that view.
 Senator DURBIN. Thank you.
 Senator Collins.

UNDERFUNDING

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Gensler, Senator Lieberman and I, as the chairman and ranking member of the Homeland Security and Governmental Affairs Committee, held three hearings last year looking at speculation in the commodities markets, and I want to talk about some of our findings as a result of those hearings.

The first we've already discussed at some length and that is that the CFTC has been woefully understaffed. We were told by the Commission that there were more than 3 billion futures and options contracts that were traded last year, I guess it would have been the year before last, and that was up from 37 million in 1976 when the Commission was first created, so 37 million to 3 billion contracts, and yet the Commission was operating with fewer employees than it had 30 years ago. Just an untenable situation.

Now, the Acting Chairman of the Commission in February wrote to the Office of Management and Budget (OMB) Director in protest of the budget that had been handed down by OMB of having a budget of \$160.6 million and he described it as perilously inadequate. He went on to say that it would not allow the Commission to implement all of its responsibilities. That is the budget that we're talking about today.

Do you disagree with the letter that was written by the Acting Chairman or do you share his concerns?

Mr. GENSLER. I share the concerns that this agency is both underfunded, as you and Senator Lieberman's panel determined last year. I think, as the Acting Chairman Mike Dunn did an excellent job these past 4 months laying out that this agency needs more. We're very appreciative of the President's budget and the 38 additional employees, but I don't think it's really yet up to the task that the American people expect or how we're going to protect against fraud, manipulation, and, as your hearings looked at, the burdens of excess speculation in these markets.

SPECULATION

Senator COLLINS. Let me turn to the speculation issue. As a result of the hearings that we held, Senator Lieberman and I introduced a bill that directed the CFTC to establish position limits that would apply to an investor's total interests in a commodity, regardless of whether they originate on a regulated exchange, the over-the-counter market or on foreign boards of trade that deal in U.S. commodities.

Do you support establishing position limits, having the Commission do it rather than the exchanges?

Mr. GENSLER. I think, Senator, that it's important that we bring a broader view of this even than was being discussed then, that we have the over-the-counter derivatives marketplace under regulation, but, in addition, that the position limits that are set—for instance, if it was for crude oil, that it would look across markets and aggregate not only internationally, as you were discussing, but also

with the over-the-counter derivatives marketplace. There may be contracts that are really quite similar, as you addressed in the farm bill, but more broadly as we work with Congress later this year and try to get aggregate position limit authority for Federal regulators to look across markets and across futures and swaps.

INDEX TRADERS

Senator COLLINS. What our hearings demonstrated was that speculation in the commodities markets by noncommercial investors, not individuals or entities that are actually taking possession of the commodity at some point, but entities, like pension funds, university endowments and other institutional investors, has grown enormously from 2003 to 2008.

In just that 5-year period the total value of their futures contract and commodity index funds investments soared from \$13 billion to \$260 billion. So you have this influx of money from speculators. There's always been speculation in the commodities futures markets.

I understand that and I understand that speculation is useful for hedging risk, but we're talking now about speculation from individuals who are not the traditional buyers and sellers of the commodity, and I understand that those investors' intention is to provide good returns as a hedge against inflation, asset diversification, but the effect of that activity cumulatively appears to drive up the price for some of the traditional users of the commodity markets.

Just a week ago Maine's fuel dealers were in my office saying that they believe excessive speculation by noncommercial players is once again driving up the cost of oil. That's a tremendous issue in a State where 80 percent of the families use home heating oil to stay warm.

So two questions. First, what is your general opinion on whether the influx of funds from nontraditional players is putting artificial price inflation or causing prices to go up beyond what they otherwise would, and second, what, if anything, should we do about it?

Mr. GENSLER. Two excellent questions. I do think that, looking back, in that period that you named and when oil prices peaked last summer, that a contributing factor, not the only factor because there were many factors, but a contributing factor to the commodity asset bubble was index investors and other financial investors.

We have also lived through other asset bubbles in housing, unfortunately, in the stock market in the late 1990s and then again maybe last year. So in a similar way, I think financial actors contributed to this but were not the only cause.

I do think that the Commodity Futures Trading Commission, at its core and has been for 70 plus years, one of its missions is to make sure that markets' integrity is sound, that there's not manipulation and fraud but also that the burdens of excessive speculation be guarded against through position limit authority.

So in terms of that mission, the Commodity Futures Trading Commission is not a price-setting agency, but it is an agency that has to guard to make sure that the markets are operating free of manipulation, free of fraud, and that through the position limit au-

thority the Congress first granted back in the 1930s, that there's some limit to the actors within the marketplace.

Senator COLLINS. Thank you.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, and thank you for those questions, Senator Collins.

I've just got a follow-up that goes right under her question and that is, do you think the marketplace right now is being impacted by—I'm talking about the oil marketplace is being impacted by trading of nontraditional traders?

Mr. GENSLER. Senator Tester, again I've only just been in the job for 6 days and mostly been preparing for this Appropriations hearing and a hearing for Thursday on other matters, so I haven't formed a view.

I do think that, just as the asset bubble broke last year with this financial crisis, that part of what we're seeing is with some confidence coming back in the stock market and in other investment markets, just as Senator Collins mentioned, some investments of firms and others are having more confidence in the value in the commodities marketplace.

But again, I've only been there 6 days and haven't, you know, been able to meet with economists and sort through the specifics of this market.

It is likely that, as economy—if we're able to get out of this recession and get away from the financial crisis, the commodity prices will move and I'm not saying where, but a lot will change in the economy, as well.

Senator TESTER. Being a farmer, I don't mind having commodity prices go up. I can tell you that the price of gasoline at the pump in Montana over the last 6 weeks has probably went up a buck a gallon. I don't see that kind of increase at the barrel level. I can still hear about ships floating around out in the ocean full of oil.

I can't make any sense of what's going on and what further frustrates me is that last year, during the last Congress, we had people in, and you're right, it was a multifaceted thing, but very, very few people would step up to the plate last year and say part of this—a good part of this is caused by speculation in the marketplace.

It was all supply and demand, supply and demand, supply and demand, and that was part of it, but I think a good part of it was just flat speculation and greed.

Mr. GENSLER. Senator Tester, as I just mentioned to Senator Collins before you arrived, I believe that index investors, hedge funds, and other pension and financial investors were a contributing factor in this asset bubble of last year. I just haven't been able to tease out exactly what's happened in my first 6 days.

Senator TESTER. I look forward to further communication, either in committee or outside the committee, on that issue because I think it's really important. I think it's really important that we make sure that we have honest markets here.

Mr. GENSLER. I fully agree with that.

MERGER

Senator TESTER. Okay. I asked a question to Secretary Schapiro about the discussions of future roles of your agency and the SEC

as we conduct a regulatory modernization effort, if they were combined, if CFTC were combined with SEC.

Can you just tell me some of the challenges, opportunities, possible consequences?

Mr. GENSLER. You said if.

Senator TESTER. That's right.

Mr. GENSLER. Well, thank you for your question, Senator. I think whether it's in Government or in commerce, it's important to consider that a merger just for merger's sake is probably not much reason to do that, whether it's in Government or in commerce.

Senator TESTER. Yeah.

Mr. GENSLER. I think some of the challenge is that each of these agencies, agencies that date back to the 1930s, have a mission to protect against fraud manipulation but with different missions.

At the CFTC, its core was around farmers and ranchers, which you know a great deal about, to protect their markets so they can hedge a risk, buy the seed and plant a crop knowing that the market pricing mechanism is honest.

That's at the core of the CFTC and if, for any reason, Congress and the President working together wanted to merge these agencies, which again I'm saying merger for merger's sake probably isn't it, we'd have to really protect that root mission, that we're protecting the pricing mechanism for farmers, ranchers, commercial users, all the users of the futures and derivatives marketplaces that the CFTC oversees.

Senator TESTER. Okay. If the President's working group recommends combining the two agencies, if again, and you believe that they should be separated, would you support the working group's regulatory modernization proposal?

Mr. GENSLER. I chair an independent regulatory agency. My responsibility, I think, to the American public would be to tell you what I believed at that time. So I think I would speak out openly and share with this subcommittee and the rest of the Congress what I thought.

DERIVATIVES REGULATION

Senator TESTER. All right. Good. Derivatives. You've been involved in a conversation on regulating or deregulating derivatives for over a decade in past positions that you've held.

Could you give me a quick synopsis, because I'm already out of time, on how your opinion of derivatives and the regulation has evolved over the last 5 to 10 years?

Mr. GENSLER. It has evolved, Senator. I think now that we must bring under regulation the over-the-counter derivatives marketplace through two complementary schemes.

One is the dealers or institutions that actually deal in these swaps, if I may call them, and that's nearly 100 percent of the market, probably in 20 or 25 big institutions. We know their names and you're familiar with them.

We should police for fraud manipulation. We should get 100 percent of the record, both for standardized and customized swaps and set capital standards at the Federal level and margin requirements through the dealer side.

But, in addition, in an additive way, also regulate the markets and then we can lower risk, we can lower risk if we have standard products go through central clearing and we can promote transparency and this is critical that we promote transparency through having regulated exchanges, as well.

Senator TESTER. Okay. Thank you very much, Mr. Chairman.

Senator DURBIN. Chairman Gensler, as you look at the volume of work that you're faced with, the new responsibilities, what do you think is the—let me state it this way.

What would you recommend as the optimal number of people that you need in your agency to do that job effectively?

Mr. GENSLER. Under the current authorities, because, of course, we'll work together with Congress and with the rest of the administration on new authorities,—thank you, Senator Tester.

Under the current authorities, the agency put forward, as Senator Collins said, an appeal letter in February that was speaking to—I think it was about 650 full-time people under that \$177 million.

I don't know yet, again through just 6 days, whether that's going to allow us to fully cover, but I agree with Acting Chairman Dunn that it's more toward that number of people and it may be as high as some figures I've seen inside that are a little higher than that, closer to the 700-person figure.

ENFORCEMENT PENALTIES: AMOUNT, RECOVERY AND DETERRENCE

Senator DURBIN. When Chairman Schapiro was here, I noted that the fees collected by her agency within the marketplace generated about 40 percent more than the annual appropriation for her agency.

Similarly, in your situation, the penalties that have been assessed for wrong-doing and the amounts collected, I've seen varying estimates of this amount, but they appear to be over the last 8 years somewhere between \$1.5 and \$2 billion your annual appropriation, for last year \$146 million, in comparison there.

So could you say to me, I mean, or could we say to those who are observing this hearing that when your agency does its job and ends up with a trustworthy marketplace, it also is engaged in enforcement actions which bring in more revenue than the actual budget of the agency?

Mr. GENSLER. I think, Mr. Chairman, that the agency—we could say to those looking at this is a sound investment of a \$160 million for the next year of taxpayer money because in helping police these markets, enforcing these markets, bringing integrity to the markets, making sure that they're fairly priced in the marketplace is the crucial thing.

But in addition, you're right, there are enforcement actions that have penalties. The penalties are at least greater than the budget. The collections tend to be a little less than that, as you know.

Senator DURBIN. How well is the CFTC able to measure the deterrent impact of these enforcement actions?

Mr. GENSLER. It's a challenge to measure the results, but we believe that the stronger we are in enforcement, just as Chairman Schapiro said, in finding some of those cases that you can really

bring the wrong-doers to bear is critical to make sure that the markets operate better.

Senator DURBIN. What is your recovery rate?

Mr. GENSLER. As I understand it, the collections on the large manipulation cases are very high. The collection on the Ponzi schemes and fraud cases, unfortunately, is very low because so often those individuals behind those cases don't have any money, but I believe it's somewhere in the 30 to 40 percent when you average out high recoveries on complex manipulations and low recoveries on these Ponzi schemes.

Senator DURBIN. I'd like your thoughts, and maybe you can share them with me in separate communication, about whether the current penalty structure is in fact at a level consistent with creating a deterrent and what additional remedies or instruments you may need for that recovery rate to improve, and I understand that, as you said, some recovery is going to be extremely difficult.

But if you would take a step back and look at those two aspects, the deterrence and recovery, and give us your thoughts on that, I would appreciate that very much.

Mr. GENSLER. We will follow up with you, Mr. Chairman.

Senator DURBIN. Thank you.

Senator Collins.

DERIVATIVES REGULATION

Senator COLLINS. Thank you, Mr. Chairman.

Just two final questions from me. Senator Levin and I have introduced a bill that would repeal the language that prohibits the Commodity Futures Trading Commission from regulating derivatives, and I understand that the administration's new proposal would give both the SEC and the CFTC new authority to regulate derivatives.

What are your thoughts on this plan and the role of the CFTC in the regulation of derivatives?

Mr. GENSLER. I wish to applaud you and Senator Levin on that bill. I believe that we have to have, working with Congress, significant amendments to the Commodities and Exchange Act and seeking the same goal, to bring all the over-the-counter derivatives marketplace under regulation.

I think the Commodity Futures Trading Commission has the lead expertise on derivatives. Futures are a form of derivatives and these things that are now called over-the-counter swaps are another form of derivatives.

Working with Chair Schapiro, I'm hopeful that we can present a unified front and, as she said, you know, there's the boundary issues are important.

I think it's critical that we not have any gaps in regulation, but we believe at the CFTC and I believe interest rate swaps, currency swaps, commodity swaps, equity swaps, credit default swaps and any swaps invented in the future that are just a blip on the radar need to come under this regulatory regime.

There may be areas where a swap is more security-like, like a single issuer credit default swap, where, of course, we need multi-agency work, insider trading and SEC, you would want very much involved in things like that.

Senator COLLINS. Actually, I would argue that the credit default swaps were more like an insurance product and yet they were not regulated by State insurance agencies either.

Mr. GENSLER. They had many insurance attributes. There were many lessons, unfortunately, out of this crisis. You were earlier asking Chair Schapiro, but I think one of the great lessons of AIG was that there was unregulated institutions. That's why I am for regulating all derivative dealers, whether they're affiliated with banks or not.

But then these products, as you say, credit default swaps, have attributes of insurance, like monoline insurance. They have attributes of securities.

Senator COLLINS. Exactly.

Mr. GENSLER. They have attributes of derivatives that the CFTC is the expert on.

Senator COLLINS. Which is why we need this council of regulators approach because the problem now is the marketplace is always going to be innovating and we want it to be innovative and producing new kinds of products and we need a system where just because a product is new does not mean that it falls into a regulatory black hole and no regulator ends up having responsibility and no regulator or regulators is looking at the impact across the financial system.

When you think of a credit default swaps situation, here we have a new product that grows into the trillions of dollars, jeopardizes the entire financial market, and yet it doesn't fall under securities, it doesn't fall under insurance, it doesn't fall under the Consumer Product Safety—I mean the Commodity Futures Trading Commission. So clearly, we need to resolve that.

Let me just turn to another loophole that our hearings took a look at and that's the so-called swaps loophole that allows financial institutions to evade position limits on commodity contracts that regulators are using to prevent unwarranted price swings or attempts at manipulation.

What should be done to close that loophole?

Mr. GENSLER. I think that explicit authority should be given to the Federal regulators, with the CFTC taking the lead on position limits, to bring the over-the-counter derivatives marketplace under a regulatory regime: that we regulate all of the dealers to make sure that they are not manipulating, that we're policing fraud, that we're policing position limits, aggregate position limits, as I referred to earlier, that we, amongst the regulators, have an enormous opportunity to see 100 percent of the transactions.

INTERNATIONAL

Senator COLLINS. Finally, do you have sufficient funds to pursue your international responsibilities?

What I'm thinking of is there is a problem with foreign exchanges and what rules they're going to play by, particularly if they're dealing with U.S. commodities which they are, and particularly when they have a presence in the United States.

I don't know whether that's an issue you've looked at yet, but the SEC seems to be far more active in that area than the CFTC is.

Mr. GENSLER. Well, Senator, you're right that we've had to make as an agency tough trade-offs, an agency that shrunk 20 percent in the last years, but thankfully with this year we'll start to move back.

There's a small Office of International Effort but it's very small, I think four or five people at the CFTC. We do share your concern and share the view that we have to make sure that foreign boards of trades that are influencing these markets and are in our markets have consistent regulation, come under the position limits and other authorities here.

Though the CFTC has moved forward in this regard, we do think that it's important to work with Congress to embed in statutes some additional authorities with regard to foreign boards of trade.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Collins.

ADDITIONAL COMMITTEE QUESTIONS

Chairman Gensler, thanks for your testimony. We're going to keep the hearing record open until next Wednesday, June 10, at 12 noon for subcommittee members to submit statements and/or questions, and we ask that the information we requested you do your best to comply with at a convenient time.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

MOST SERIOUS MANAGEMENT CHALLENGES IDENTIFIED BY INSPECTOR GENERAL

Question. The Reports Consolidation Act of 2000 requires the Inspector General to summarize the "most serious" management and performance challenges facing the Commodity Futures Trading Commission (CFTC). In the Inspector General's assessment report of November 14, 2008, the Inspector General identified two management challenges for fiscal year 2009.

The first concern is with the Modernization of Electronic Market Surveillance. The Inspector General explains that while market surveillance has always been an integral part of CFTC operations, the past years have witnessed the transformation of futures trading from an open outcry trading floor based system to an electronic system. In fact, in 2008, electronic trading accounted for 84 percent of total exchange traded derivatives.

The second area is the Efficient Acquisition and Integration of Skilled Human Capital. The Inspector General cites the fact that recent economic turbulence has stimulated an interest in applying the historically successful centralized clearing mechanism to the bilateral and complex swap markets. The Inspector General expressed skepticism that the CFTC currently has the human capital to monitor these complex markets and that situation may demand review of existing hiring procedures.

Chairman Gensler, have you had an opportunity to review the Inspector General's analysis?

What is your reaction?

What is your plan for prioritizing these two key items in your management agenda?

Answer. Yes, certainly the need to modernize electronic market surveillance will require additional technological capabilities. It is also apparent that if the Congress entrusts the Commission with significant additional responsibilities, the Commission will need to expand its staff and pay particular attention to needed skill sets. The Congress provided the Commission with substantial additional funds for fiscal year 2009. At this point we have almost completed hiring the new staff funded for this year. I asked the staff to provide the following information on the modernization of electronic market surveillance:

In late 2008, the CFTC contracted with the Promontory Group to review the market surveillance program. Commission staff is finalizing its assessment of the Promontory report and preparing recommendations for the Commission. The objective is to ensure that the CFTC has an effective approach to surveillance, from both a programmatic and operational perspective.

The CFTC also is in the process of modernizing its trade surveillance system in order to perform its statutorily mandated oversight functions and to keep pace with the explosive growth in electronic trading. In 2007, the CFTC's Division of Market Oversight ("DMO") and Office of Information and Technology Services ("OITS") embarked on a multi-year plan to develop a new trade surveillance system ("TSS"), to replace the Commission's antiquated system. TSS is designed as a database of exchange data maintained by the Commission which can be evaluated with off-the-shelf alert and analysis tools. A contract was awarded to Actimize in 2008 to deliver such a product. OITS expects to have all of the exchanges connected to the Actimize tool by the end of the first quarter 2010.

A challenge to the Commission in implementing TSS has been a lack of data uniformity. To resolve this problem, in May 2007, DMO formed a subcommittee through the Joint Compliance Committee to discuss and formulate a plan for using "FIXML" as a standardized format for trade data submitted to the Commission and to formulate a FIXML transition plan. In December of 2008, a schedule was presented to all exchanges for submission of trade data in FIXML by the end of 2009.

The Commission has also been working to better link its trade surveillance and market surveillance systems. Currently, the Commission is unable to connect accounts identified by large traders with their intra-day transactions. To resolve this problem, the Commission has issued an advanced notice of proposed rulemaking to solicit comments on the collection of account ownership and control information from exchanges. Such information would be used to improve DMO surveillance by serving as an adjunct to the CFTC's ISS (large trader position data) and TSS databases.

ADEQUACY OF FUNDING TO PERMIT PAY PARITY

Question. In response to the 1980s banking crisis, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Public Law 101-73) which provided for pay parity among federal financial regulatory agencies.

The Commodity Futures Trading Commission was granted comparable pay authority (Public Law 107-171) with other financial agencies to level the playing field with a goal of attracting the best and brightest talent. Despite the authorization, the CFTC has not been fully funded to the level of comparable agencies covered under the law.

During recent years, the Commodity Futures Trading Commission's budget situation has resulted in hiring freezes and has not permitted a meaningful review by the IG to determine its effect on employee retention and whether new hires are appreciably more experienced or better qualified.

Chairman Gensler, what has been the practical impact of the CFTC's not having sufficient annual budget authority to accomplish pay parity for your workforce?

Answer. The Commission is currently near pay parity with the other FIRREA agencies with regard to pay, having implemented merit pay and new pay ranges. There are several areas where we need to align the Commission with the FIRREA agencies; these include personnel benefits and possibly some job reclassification.

The implementation of pay parity without sufficient budget authority has had the same practical effect as meeting all other resources challenges without sufficient budget authority—the Commission froze and/or restricted hiring and deferred investment in Information Technology. These steps were taken after exhausting all other savings from administrative efficiencies.

Question. To what extent has the CFTC's inability to compensate staff at comparable levels led to departures of experienced personnel to positions in other Federal financial regulatory agencies?

Answer. Since the Commission is currently comparable with other FIRREA agencies with regard to pay, and nearly comparable with regard to benefits, the Commission is no longer losing, as it once did, a significant number of staff to other financial regulatory agencies as a result of inadequate compensation. However, those past losses tell us it is important that the Commission maintain comparability with these agencies.

Question. What funding level would permit the CFTC to move toward providing pay parity?

Answer. The fiscal year 2010 budget includes approximately \$1.4 million that would permit the Commission increased contribution to personnel benefits package thereby making it more comparable to FIRREA agencies. Funding would also permit

the Commission to reclassify selected positions if an ongoing review concludes that is appropriate to support parity and to improve recruitment and retention.

Question. As CFTC Chairman, what are your goals in this area?

Answer. As a new Chairman I look forward to reviewing the findings and recommendations of the Commission Pay Parity Governance Committee before advancing any new goals of my own. However, I am committed to ensuring that the Commission receives adequate funding to stay comparable with our fellow financial regulatory agencies.

Question. When does the CFTC plan to institute a student loan repayment program as a recruitment and retention tool?

Answer. Our goal is to implement a student loan repayment program by the end of the year.

Question. What resources would that require?

Answer. We have initially set aside \$200,000 for the implementation of this program.

DERIVATIVES MARKET REGULATORY REFORM

Question. Derivatives—contracts between two investors betting on whether a stock, bond, or other security will go up or down in value—has ballooned into the world's largest trading market, estimated to be in the tens of trillions of dollars. Much of the activity is not currently under a regulatory apparatus.

This market has also helped catalyze the current economic crisis. Losses on one type of derivative known as credit-default swaps helped topple American International Group (AIG), prompting a government bailout that has grown to \$180 billion.

On May 13, President Obama unveiled a plan to regulate the derivatives market. This proposal includes new rules to restrict banks, hedge funds, and other investors, and has four goals: (1) force the trade of most derivatives through a regulated clearinghouse and require traders to report activities and hold a minimal level of capital to cover losses; (2) improve oversight by ensuring clearinghouses and firms dealing in derivatives provide copious information to regulators about their trades; (3) empower regulators to force traders to submit detailed information and pursue cases of fraud and manipulation; and (4) prevent derivatives from being marketed to groups that may not understand their complexities.

How would expanded derivatives regulation impact the CFTC workload? What budgetary considerations need to be considered?

Answer. We must establish a comprehensive regulatory regime to cover the entire over-the-counter derivatives marketplace. This will help the American public by: (1) lowering systemic risk; (2) providing transparency and efficiency in markets; (3) ensuring market integrity by preventing fraud, manipulation, and other abuses; and (4) protecting the retail public. I envision this will require two complementary regimes—one for regulation of the dealers and one for regulation of the market functions.

The Department of the Treasury, on behalf of the Administration, has submitted legislation to Congress to regulate the over-the-counter (OTC) markets. Although some improvements are appropriate to ensure that we best meet the goals stated above, the Administration's comprehensive proposal is consistent with regulatory reforms that the CFTC has proposed in testimony to Congress. The Administration's proposal will lower risk by requiring capital and margin on dealers and mandatory clearing of all standardized products. It will enhance market integrity by protecting against fraud, manipulation, and other abuses and establishing new authorities to set aggregate position limits. It will promote transparency and market efficiency by requiring recordkeeping and reporting for all derivatives and requiring that standardized derivatives be traded on transparent trading platforms.

Of course there would be a need for some additional resources at the CFTC to handle this expanded regulatory obligation. Until the nature and scope of the regulation of OTC derivatives markets is determined by the Congress, the resources necessary for implementation cannot be predicted with certainty.

Whatever the cost of regulation, it will pale in comparison to the cost of doing nothing. If the current financial crisis has taught us anything, it is that the derivatives trading activities of a single firm can threaten the entire financial system. The costs to the public from the failure of these firms has been staggering, \$180 billion of American taxpayer financial support for AIG alone. The AIG subsidiary that dealt in derivatives was not subject to any effective federal regulation.

MEMORANDUM OF UNDERSTANDING BETWEEN CFTC AND SEC

Question. Last year (March 11, 2008), then-Commodity Futures Trading Commission (CFTC) Acting Chairman Walter Lukken and then-Securities and Exchange Commission (SEC) Chairman Christopher Cox entered into a formal "Memorandum of Understanding" (MOU) setting forth several principles designed to guide inter-agency collaboration. The premise of this agreement was to seal some of the regulatory gaps and better accommodate new products that blur the lines between the futures and the securities worlds.

The MOU establishes a permanent regulatory liaison between the CFTC and SEC; requires quarterly joint meetings of staff; sets up a framework for extensive information sharing and exchange confirms existing enforcement policies; creates guidelines for new financial products that combine elements of securities, futures, or options; and addresses jurisdictional overlaps.

Chairman Gensler, can you describe some of the benefits to the CFTC since entering into the MOU with the SEC in March 2008?

Answer. The MOU has provided a formal mechanism to assure dialogue among senior staff of the two agencies regarding the treatment of novel derivative products and other issues of mutual regulatory interest. In addition, following on the MOU, the CFTC and SEC Divisions of Enforcement undertook efforts to improve coordination and cooperation. Specifically, in the summer of 2008, the CFTC and SEC Divisions of Enforcement appointed senior staff to serve as liaisons for their respective agencies, and also established quarterly meetings to discuss issues related to investigation and litigation dockets for matters of common concern. The enhanced cooperation between the CFTC and SEC Divisions of Enforcement is also reflected in the May 2009 joint training session for enforcement staff in which experts from both agencies discussed strategies regarding the agencies' coordination, investigation and prosecution of several recent Ponzi fraud matters.

Question. What impediments hinder CFTC's ability to oversee and regulate new products that have mixed characteristics of futures and securities?

Answer. Neither the CFTC nor the SEC currently has regulatory jurisdiction with respect to OTC derivatives transactions, some of which are relevant to both the futures and the securities markets. In areas where jurisdiction does exist, further enhanced communication between the CFTC and SEC staff—specifically, ongoing communications regarding whether activity detected by one agency implicates the jurisdiction of the other agency—will improve the CFTC's ability to oversee and regulate such new products.

Question. How do you intend to collaborate with SEC Chairman Schapiro in advancing the goals of this MOU?

Answer. In addition to direct communications with Chairman Schapiro, as we have done in discussing regulatory reform with respect to OTC derivatives, I anticipate that Chairman Schapiro and I will actively direct and guide our respective staffs to fulfill the objectives of the MOU. We will work cooperatively and collaboratively to remove unnecessary duplication and other regulatory roadblocks to innovative market developments, while assuring that there are no regulatory gaps that endanger the public interest. The agencies' focus on this goal is currently reflected in our joint harmonization project, including the unprecedented joint meetings recently held by our two Commissions.

Question. Do you envision the need for any modifications to the agreement to strengthen the current interagency relationship?

Answer. The MOU was intended to be a "living" document. Just as the agencies have entered into an Addendum to the MOU with respect to novel derivative products, additional Addenda may be considered as the agencies address new issues and harmonization on a going-forward basis.

ENFORCEMENT ACTIONS TO PRESERVE MARKET INTEGRITY AND PROTECT MARKET USERS

Question. Detecting and deterring against illegitimate market forces requires CFTC's steady vigilance and swift response. Over the past 8 years, CFTC has assessed over \$2 billion in civil penalties against perpetrators of various fraud schemes. For instance:

- To address manipulation, attempted manipulation, and false reporting in the energy arena, the CFTC filed 43 enforcement actions against 73 entities or individuals in the December 2001 to September 2008 period resulting in \$445.5 million in assessed civil penalties.
- To address misconduct in connection with commodity pools and hedge funds by unscrupulous and unregistered operators and advisors, from October 2000 and September 2008, the CFTC filed 73 enforcement actions against 24 entities, with \$564.13 million in penalties assessed.

—To combat the problem of foreign currency (forex) fraud, between December 2000 and September 2008, on behalf of nearly 26,000 affected customers, the CFTC has filed 98 enforcement actions, charging 374 entities or persons, culminating in over \$562 million in civil monetary penalties and \$454 million in restitution.

How well is the CFTC able to measure the deterrent effect of these enforcement actions?

Answer. Measuring the deterrence effect of enforcement actions remains a challenge to the CFTC and other law enforcement agencies. The CFTC has undertaken a number of actions to increase deterrence as noted below by staff:

—The CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. In cases of ongoing fraud, the CFTC's objective is to bring its enforcement action as quickly as practicable in order to stop the fraud, freeze assets, and preserve books and records. The CFTC also leverages the impact of its enforcement actions by working cooperatively with federal and state criminal and civil authorities who often bring their own actions based upon the conduct that violates the Commodity Exchange Act and CFTC Regulations. Whenever the CFTC files an enforcement action and obtains a final judgment in one of its enforcement actions, it publicizes these events through press releases and media interviews. To alert market users and the public to the dangers of fraud, the CFTC has issued a number of Consumer Advisories warning the investing public of potential risks and scams, and has posted these Advisories on its website. The CFTC also seeks to maximize the deterrent effect of its enforcement program by tracking industry trends. For example, the CFTC's Acting Director of Enforcement gave Congressional testimony in June 2009 regarding the observed uptick in fraud involving solicitation of retail customers for purported off-exchange transactions in precious metals, and certain energy and agricultural products. The fraudsters appear to have drafted customer agreements to make them appear to be spot contracts outside of CFTC jurisdiction and not futures contracts covered by the Commodity Exchange Act.

—The CFTC remains committed to developing improved performance measures to reflect the deterrence effect of its enforcement program. For example, the CFTC has requested funds every year since the fiscal year 2007 OMB budget request thru fiscal year 2010, to study the performance measurement issue, however, funds, to date, have not been approved.

Question. How rapidly are you able to collect restitution, disgorgement of ill-gotten gains, and civil monetary penalties imposed against violations of the federal commodities laws?

Answer. When the CFTC files enforcement actions that include allegations of fraud, its general practice is to seek a statutory restraining order to immediately freeze the defendants' known assets, including trading and bank accounts, homes and other real property and cars. These assets are then preserved for purposes of customer restitution or disgorgement at the conclusion of a successful prosecution. The CFTC Division of Enforcement may also request that the federal district court order defendants to make an accounting, which assists the CFTC in tracking money flows and identifying additional assets for recovery. The CFTC also names as relief defendants in its enforcement actions persons known to have received funds derived from the fraud and to which they have no legitimate claim, and seeks to freeze and recover these funds for return to customers as well. At the conclusion of litigation, and in the event of a remaining judgment, the Commission follows an established protocol to ensure that matters are appropriately referred to the Department of Justice and Department of the Treasury for collection.

Question. What is the annual recovery rate?

Answer. Staff has supplied the following information:

Below is a table that sets out the CFTC's annual recovery rate for civil monetary penalties assessed for fiscal years 1992 through 2008.

CIVIL MONETARY PENALTIES ¹
[Fiscal year 1992-fiscal year 2008]

| Fiscal year | Penalties imposed | Penalties collected |
|-------------|-------------------|---------------------|
| 1992 | \$3,207,277 | \$2,285,664 |
| 1993 | 3,313,100 | 3,514,715 |
| 1994 | 4,112,407 | 3,134,266 |
| 1995 | 11,201,100 | 9,430,239 |
| 1996 | 1,335,000 | 1,526,000 |

CIVIL MONETARY PENALTIES ¹—Continued

[Fiscal year 1992-fiscal year 2008]

| Fiscal year | Penalties imposed | Penalties collected |
|-------------|-------------------|---------------------|
| 1997 | 4,532,000 | 1,752,636 |
| 1998 | 132,623,756 | 125,803,781 |
| 1999 | 85,863,311 | 22,165,368 |
| 2000 | 179,811,562 | 3,299,362 |
| 2001 | 16,876,335 | 3,170,252 |
| 2002 | 9,942,382 | 5,922,387 |
| 2003 | 110,264,932 | 87,699,077 |
| 2004 | 302,049,939 | 122,468,925 |
| 2005 | 76,672,758 | 34,163,077 |
| 2006 | 192,921,794 | 12,364,509 |
| 2007 | 345,614,139 | 17,137,848 |
| 2008 | 234,835,171 | 140,745,252 |

¹The discrepancy between the amount of civil penalties imposed and the amount collected is accounted for by the following factors: (1) when courts order the defendants to both pay restitution to victims and a civil monetary penalty to the Government, established Commission policy directs available funds to satisfy restitution obligations first; (2) in fraud actions, it is not uncommon that the proceeds of the fraud have been dissipated and/or that the penalty far exceeds the defendants' represented financial ability to pay; (3) delinquencies assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (4) penalties imposed in one year may not become due and payable until the next year; (5) a penalty may be stayed by appeal; (6) some penalties call for installment payments that may span more than 1 year; (7) penalties have been referred to the Attorney General for collection, and (8) collection may still be in process.

Question. What has been the impact of more sophisticated information technology to monitor and detect fraud more readily?

Answer. In the enforcement arena for fraud cases, information technology assists in asset tracing, account reconstruction, and electronic data recovery of financial records. Improvements in information technology have improved the CFTC's search capability for evidence of illegal activity involving Internet websites, instant messages, e-mail and audio.

In the regulatory arena, as discussed above, the CFTC is currently implementing its new trade practice surveillance system (TSS). TSS is designed as a database of exchange trade data maintained by the Commission upon which off-the-shelf alert and analysis tools can be connected. A contract was awarded to Actimize in 2008 to deliver an alert and analysis tool that has the capability to perform sophisticated pattern recognition and data mining to automate basic trade practice surveillance, and to detect novel and complex abusive practices. TSS also will fill a vacuum in inter-market surveillance which only the Commission can address, e.g., where NYMEX and NYSE Liffe both list metals contracts.

Question. Are there any statutory or administrative impediments that prevent the CFTC from doing more to combat fraud?

Answer. As noted above, the CFTC has observed an upswing in retail customer complaints regarding potential fraud involving off-exchange transactions in precious metals, energy products and agricultural commodities. It appears that fraudsters are drawing upon the adverse precedent of a line of cases under *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), in which the Seventh Circuit held that certain contracts were spot transactions beyond the jurisdiction of the CFTC. Congress addressed this problem in the CFTC Reauthorization legislation included in the 2008 Farm Bill with respect to Zelener-type foreign currency transactions. A similar fix is needed if the CFTC is to effectively prosecute boiler rooms offering Zelener-type contracts in metal, energy, and other commodity contracts to retail customers (and is included in the Administration's proposed OTC derivatives reform legislation).

In addition, in the wake of the decision in *CFTC v. Wilshire*, 531 F.3d 1339 (11th Cir. 2008), defendants in fraud cases increasingly are asserting that federal courts lack authority under the Commodity Exchange Act to award restitution based on customer losses suffered as a result of the fraud. *Wilshire* held that the proper measure of restitution is the gain to the wrongdoer, rather than the losses suffered by customers. In cases where the fraudster retains only a small portion of the monies fraudulently induced from customers, this limit on restitution threatens the CFTC's ability to obtain make-whole relief for defrauded customers.

Staff advises that additional statutory measures that may increase the CFTC's ability to combat fraud include, among others, the following:

—Amendment of the Privacy Act to clarify that CFTC investigators may seek promotional material and verbal sales solicitations without identifying themselves as CFTC employees or providing personal information as to their true identity.

—In Section 4n of the Commodity Exchange Act, provide authority to require accountants to maintain records of audit activity concerning commodity pools that would be available for inspection by the CFTC.

—Clarify that the CFTC need not show criminal intent in actions based on conversion under Section 9(a)(1) of the Commodity Exchange Act.

Question. Is the current penalty structure designed to serve as an effective deterrent?

Answer. Yes. Commission staff supplies the following background:

—Section 6(e) of the Act, 7 U.S.C. § 13a-1(d), instructs the Commission to impose a civil monetary penalty that is appropriate to the gravity of the violation. Commission precedent has long recognized the importance of deterrence in preventing violations, most recently in *In re DiPlacido* [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶30,970 (CFTC Nov. 5, 2008) (“[g]iven the gravity of DiPlacido’s offenses and potential maximum fine, the focus of the Commission’s analysis shifts to assessing a specific penalty appropriate to the level of gravity and suitable to deter future violations”). Indeed, the Commission signaled the paramount role that deterrence plays when it emphasized that “[i]n imposing monetary sanctions, the primary focus of the Commission’s analysis has been deterrence.” *In re Murlas*, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,440 at 35,929 (CFTC Apr. 24, 1989) (emphasis added).

—Also, in last year’s CFTC Reauthorization legislation, Congress increased the maximum civil monetary penalty for manipulation, attempted manipulation, and false reporting to \$1 million per violation. See Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008); 7 U.S.C. § 13(a).

Question. What additional remedies or authorities might be useful to boost your recovery rate?

Answer. Staff has advised that additional statutory measures that could potentially boost the CFTC’s recovery rate include, among others, the following:

—Similar to provision for non-payment of penalties imposed in CFTC administrative enforcement actions (see Section 6(e)(2) of the Commodity Exchange Act), provide that a defendant’s non-payment of civil monetary penalties imposed in enforcement actions in federal court shall result in the non-paying defendant automatically being prohibited from trading and automatically suspending any applicable registration until the defendant pays the full amount of the penalty, with interest to the date of the payment.

—Provide that collection of judgments and orders in fraud actions shall not be subject to State homestead exemptions or other State or local impediments to collection.

—Provide that disgorgement and restitution awarded in CFTC enforcement actions are non-dischargeable in bankruptcy.

—Add disgorgement as an available sanction in administrative enforcement proceedings.

PERFORMANCE GOALS/MEASURING OUTCOMES

Question. The Commodity Futures Trading Commission (CFTC)’s performance-based budget for fiscal year 2010 delineates four specific goals tied to the agency’s overall mission. For each of the goals, several outcomes are specified.

First Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$48.2 million (or 30 percent of the total funding) and 185 FTE to meet the first goal—to ensure the economic vitality of commodity futures and options markets.

The outcomes to be achieved as a result of the investment made related to this goal are markets that accurately reflect the forces of supply and demand for the underlying commodity, are free of disruptive activity, and are effectively and efficiently monitored to ensure early warning of potential problems or issues.

How does (or will) the CFTC measure whether and how well these outcomes are achieved?

Answer. The Commission has developed nine performance measures intended to measure progress in achieving the stated outcome objective. The performance results along with an annual performance analysis and review are included in pages 46–55 of the Fiscal Year 2008 Performance and Accountability Report available on the CFTC website at: www.cftc.gov/aboutthecftc/cftcreports.

Question. How does the CFTC intend to meet a performance goal of “no price manipulations or other disruptive activities that would cause loss of confidence or negatively affect price discovery or risk shifting”?

Answer. This goal is fundamentally tied to the Commission's mission and is a priority of the Commission market surveillance and enforcement efforts as noted by staff below:

—Continuous monitoring of market activity is the principal way the Commission seeks to protect the economic function of the markets. Effective market surveillance requires sufficient staff with expertise in each of the diverse markets under the Commission's jurisdiction. The Commission takes preventive measures to ensure that market prices accurately reflect fundamental supply and demand conditions, including the routine daily monitoring of large trader positions, futures and cash prices, price relationships, and supply and demand factors in order to detect threats of price manipulation.

—As discussed above, the CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. The CFTC also leverages the deterrent impact of its enforcement actions by working cooperatively with other federal criminal authorities who often bring their own actions based upon the conduct that violates the Act and CFTC Regulations.

Question. When it comes to a performance goal of "improving effectiveness and efficiency of market surveillance" what indicators will be used to determine if you have indeed reached this goal and how well? What is the baseline from which progress is to be measured?

Answer. A strategic priority of the Commission is to enhance the Commission's technological capability, improve data standards, and enhance in-house human analytical and decisionmaking capability—each in order to recognize, understand and adapt to market changes early on. Indicators of success will be progress in achieving the following tasks: upgrading ISS to get more timely market position information and to integrate trading data with position data; developing capability to provide real-time margin and settlement information; promoting data standards throughout the industry; developing and implementing sophisticated trade surveillance systems; developing automated capability to analyze and integrate off-exchange data as it relates to surveillance and investigations; developing a recruitment plan to address required skills; identifying needed competencies and developing a training plan that empowers employees to react quickly in understanding and resolving regulatory matters. Each of these tasks represents a strategic need of the Commission that is not currently being met adequately.

Question. Second Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$42.9 million (or 27 percent of the total funding) and 160 FTE to meet the second goal—to protect market users and the public. The three outcomes to be achieved as a result of the investment made related to this goal are better detection and prevention of violations of commodities laws, high standards for professionals, and expeditious handling of customer complaints.

How does the CFTC plan to increase the probability of violators being detected and sanctioned?

Is this readily measurable?

What is the baseline against which future performance will be gauged?

Answer. Having sufficient resources to pursue violations is key to increasing the probability of violators being detected and sanctioned. The Commission has developed four performance measures to assess progress in detecting violators. The performance results along with an annual performance analysis and review are included in pages 58–63 of the Fiscal Year 2008 Performance and Accountability Report available of the CFTC Web-site at: www.cftc.gov/aboutthecftc/cftereports.

Like all enforcement programs, we face a challenge in establishing overall performance measures that indicate the percentage of violative activity deterred, since no way has yet been devised to measure the total universe of violative activity that exists. The Commission keeps extensive records on the number of investigations opened and cases filed during the year, the number and amount of sanctions obtained, as well as the number of cases filed by criminal and civil law enforcement authorities that included cooperative assistance from the Commission. However, these statistics do not measure complexity of the matters opened and filed. For example, the Commission met its performance target in fiscal year 2008 with regard to the number of enforcement investigations opened. However, commencing in 2002, the complexity of Commission investigations has increased substantially over prior years (including the Commission's investigation of alleged energy market manipulation). As a result of these investigations, the complexity of the Commission's cases filed and litigated also has increased substantially since 2002. The Commission's performance target tries to take into account both of these factors but they cannot be predicated with precision.

Question. How will the CFTC ensure there are "zero unregistered, untested, or unlicensed commodity professionals (unless they are exempt from registration)"?

Answer. There are several complementary aspects to the Commission's program that ensure compliance with registration requirements as summarized by staff below:

—*Registration and NFA Membership.*—Under Section 17 of the Commodity Exchange Act ("CEA"), the National Futures Association ("NFA") performs registration functions on behalf of the CFTC. NFA registers members through its Online Registration System ("ORS") a web-based registration and membership filing and processing system. With certain exceptions, all persons and organizations that intend to do business as futures professionals must register under the CEA. The primary purposes of registration are to screen an applicant's fitness to engage in business as a futures professional and to identify those individuals and organizations whose activities are subject to federal regulation.

In addition, all individuals and firms that wish to conduct futures-related business with the public must apply for NFA membership or associate status. Mandatory membership serves an important function: NFA Bylaw 1101 prohibits members from conducting customer business with non-NFA members.

—*Testing.*—Individuals who are applying for NFA membership as a sole proprietor FCM, IB, CPO, CTA or for registration as an AP of any of these categories must satisfy proficiency requirements. Applicants generally must have passed the National Commodity Futures Examination (NCFE or Series 3) within the 2 years preceding their application.

—*Ethics Training.*—The CFTC Statement of Acceptable Practices (see Appendix B to Part 3 of the Commission's regulations) for ethics training allows flexibility, permitting firms to tailor their training programs to best suit their particular operations. In an Interpretive Notice to its Compliance Rule 2-9, NFA states that good business practice dictates that employees receive periodic training to keep them cognizant of new developments in technology, commercial practices and regulations, and their ethical implications.

—*Oversight.*—NFA conducts ongoing audits of its registrants for compliance with NFA rules. In turn, Commission staff pursues formal and ongoing oversight of NFA's compliance and registration programs. Formal oversight activities involve periodic reviews of NFA programs and inspection of records and interviews with NFA staff.

NFA pursues statutory disqualification and other disciplinary matters through Registration, Compliance & Legal Committee ("RCLC") cases. On a quarterly basis, Commission staff meets with NFA to provide guidance on registration issues generally, and to review the past quarter's RCLC cases.

These oversight activities are designed to protect market participants and the public interest by ensuring that persons who deal with customers and those who handle customer orders and funds meet the standards for fitness and integrity established under the Commodity Exchange Act.

Question. What type of tracking system is in place to demonstrate that this outcome has been achieved?

Answer. Currently, there are more than 67,000 individuals and companies registered with the CFTC in some capacity. Although it would be impossible to track the negative (i.e., that there are unregistered individuals conducting business), through its oversight of NFA's registration program, the Commission ensures both that qualified applicants are properly registered, and that unqualified applicants (or registrants) are denied registration (or have their registration revoked). Through the quarterly meetings of the Registration Working Group involving CFTC and NFA staff, the Commission ensures that standards for such actions are applied consistently, and gives guidance when questions arise.

Question. With regard to meeting timeframes for resolution of customer complaints, how does the CFTC track disposition of complaints, proceedings, and appeals in order to show that the targets are achieved in the caseload?

Answer. The various Divisions at the CFTC (Enforcement, Clearing and Intermediary Oversight, Market Oversight, and General Counsel's Office) each operate an "officer of the day program" to receive, and address or refer, inquiries (including complaints) from members of the public. The Office of Proceedings handles and tracks the disposition of adjudicatory matters at the hearing level. With respect to adjudicatory appeals to the Commission, pending cases are maintained with the Secretariat, with monthly status reports issued by the Office of General Counsel.

Question. Third Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$38 million (or 24 percent of the total funding) and 144 FTE to meet the third goal—to ensure market integrity in order to foster open, competitive, and financially sound markets

The outcomes to be achieved as a result of the investment made related to this goal are that clearing organizations and firms holding customer funds have sound financial practices, commodity futures and options markets are effectively self-regulated, markets are free of trade practice abuses, and the regulatory environment is flexible and responsive to evolving market conditions.

How will the CFTC work to ensure zero loss of customer funds as a result of firms' failure to adhere to regulations and ensure that no customers are prevented from transferring funds from failing firms to sound firms?

What mechanisms does the CFTC have to monitor self-regulatory organizations to ensure that no funds are lost as a result of the failure of SRPs to comply with their rules?

Answer. Again, the Commission has several complementary programs that address the protection of customer funds held by FCMs) and derivatives clearing organizations ("DCOs"). They are summarized by staff below:

—*Protection of Customer Funds—Statute and Regulations.*—The Commodity Exchange Act and Commission regulations require each FCM to segregate from its own assets all money, securities or property deposited by customers to margin or secure futures and option on futures positions traded on designated contract markets or funds that accrue to customers from these open positions. Each FCM also must set aside in accounts (i.e., "secured accounts"), separate from its proprietary accounts, sufficient funds deposited by customers trading on non-United States futures markets to meet its obligations to customers trading on foreign markets.

—*Notification.*—Commission regulations also require each FCM to perform daily calculations demonstrating compliance with the segregation and secured amount requirements. Any FCM that does not maintain sufficient funds in segregated accounts or in secured accounts, as applicable, to meet its obligations to its customers (i.e., is "under segregated") is required to provide immediate telephone notice, confirmed immediately in writing, to the Commission and to the FCM's self-regulatory organization ("SRO") that conducts financial surveillance over the firm.

—*Commission and SRO Responsive Action (Direct Examinations).*—Upon receipt of a notice, Commission staff work with the applicable SRO to determine the facts and to assess whether the situation is a temporary under segregation that can be immediately rectified by the FCM infusing additional funds into segregated or secured accounts, or indicative of a more serious issue that may require prompt SRO or Commission action to protect customer funds. In certain situations, Commission and/or SRO staff may conduct an immediate onsite examination of the firm's books and records to assess the FCM's compliance with its financial requirements.

—*SRO Oversight.*—The Commission conducts periodic reviews of SROs' financial surveillance programs. The SROs' financial surveillance programs include routine examinations of FCMs to assess their compliance with Commission and SRO minimum financial requirements and related reporting requirements, including minimum capital requirements and compliance with the segregation and secured amount requirements. The Commission and SROs also may conduct an examination of an FCM on an exigent basis in response to an FCM filing a notice that it is not in compliance with the customer funds segregation or secured amount requirements. Experience has demonstrated that if the Commission and SROs can react promptly at the initial signs of weakness in the financial condition of an FCM, it is more certain that customer funds will be protected. In this regard, open futures and options on futures positions may be expeditiously transferred to another FCM if the FCM that is experiencing financial difficulties has properly segregated and secured customer funds.

—*Communication With SROs.*—Commission staff hold periodic meetings with the financial surveillance staff of the SROs for the purpose of discussing emerging issues and to coordinate examination procedures and policies. This includes an annual review of the detailed SRO audit programs, which are submitted to the Commission for review.

The resources requested by the Commission for the protection of customer funds would allow Commission staff to conduct more frequent assessment of the SROs' execution of their financial surveillance programs. Additional resources would also allow the Commission to conduct more frequent direct examinations of FCMs for compliance with financial and other requirements, including the segregation of customer funds.

—*Risk Surveillance Program.*—The Commission's risk surveillance and DCO review programs also serve to protect customer funds by (i) identifying traders that pose risks to firms and firms that pose risks to DCOs, and (ii) taking steps

to mitigate those risks thereby decreasing the likelihood of default. Additional resources would allow the Commission to enhance these programs.

Question. What are the advantages and disadvantages of "regulatory restructuring" from the perspective of the CFTC?

Answer. Exchange traded futures and options contracts are derivatives relied upon by the nation's businesses for price discovery and risk management. The CFTC's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets. Like exchange traded futures, OTC swaps and similar transactions are derivatives. Like futures, OTC derivatives are used for risk shifting purposes. In recent years the OTC market has grown to far exceed the exchange traded market in size. Bringing OTC dealers and markets under CFTC regulatory oversight will greatly enhance the ability of the Commission to fulfill its mission and to protect the price discovery and risk shifting functions of derivatives markets. Additionally, bringing the OTC dealers and markets under federal regulation will significantly improve financial integrity and transparency, qualities that were lacking in the collapse of firms like AIG and Lehman Brothers.

Question. Fourth Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$31.5 million (or 19 percent of the total funding) and 121 FTE to meet the first goal—to facilitate agency performance through organizational and managerial excellence, efficient use of resources, and effective mission support.

Among the outcomes to be achieved as a result of the investment made related to this goal are a productive, technically competent, competitively compensated and diverse workforce, a modern and secure information system, and an organizational infrastructure that effectively and efficiently responds to and anticipates both the routine and emergency business needs of the agency.

How does the CFTC intend to measure progress and the extent to which these outcomes have been achieved?

Answer. The Commission has developed 18 performance measures intended to measure progress in achieving the stated outcome objective. Of the 18 measures 11 results were determined to be effective, one was determined to be moderately effective, and six were determined to be adequate. The performance results along with an annual performance analysis and review are included in pages 91–110 of the Fiscal Year 2008 Performance and Accountability Report available on the CFTC Website at: www.cftc.gov/aboutthecftc/cftcreports.

QUESTION SUBMITTED BY SENATOR SUSAN COLLINS

Question. Excessive speculation in the commodities market is prohibited under CFTC's statutes. However, determining what constitutes excessive speculation is a thorny question. Last year, as oil and other commodities skyrocketed on the futures market, many in Congress became concerned that these market prices were more reflective of the activity of speculators than commercial interests in the underlying product. Last year, under the leadership of Chairman Lukken, the CFTC stated that despite the rapid increase in prices, the data did not reflect manipulation by speculators. Critics, however, contend that in this arena, the CFTC is simply outmatched. It lacks the manpower and resources to effectively collect the large volume of data in the commodities markets and to effectively analyze that data. Do you believe the CFTC needs more resources to gather relevant data and effectively analyze it to better understand the role and the effects of speculators?

Answer. The Commission examines markets by studying the behavior of commercial and non-commercial traders. In determining the status of traders, the Commission has traditionally accepted their self-classification. The Commission has begun to examine trader patterns to ascertain the general accuracy of these classifications. Commission assessments of the self-classifications are staff intensive and in order to accomplish them expeditiously and on a sustained basis, additional resources will be required.

On another front the Commission relies on market positions information that is updated daily. Without intraday position information, the Commission cannot examine any price effect occurring on the same day as a position change. This problem could be addressed were position information available throughout the trading day. Obtaining and processing such information will require additional resources for both staff and data processing capacity.

SUBCOMMITTEE RECESS

Senator DURBIN. Thank you very much for coming in.

Mr. GENSLER. Thank you, Mr. Chairman, Ranking Member Collins. Thank you so much.

Senator DURBIN. Thank you very much.

The subcommittee hearing is hereby recessed.

[Whereupon, at 12:27 p.m., Tuesday, June 2, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

REGULATORY REFORM AND THE DERIVATIVES MARKET

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
JUNE 4, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

54-570 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

PATRICK J. LEAHY, Vermont
KENT CONRAD, North Dakota
MAX BAUCUS, Montana
BLANCHE L. LINCOLN, Arkansas
DEBBIE A. STABENOW, Michigan
E. BENJAMIN NELSON, Nebraska
SHERROD BROWN, Ohio
ROBERT P. CASEY, Jr., Pennsylvania
AMY KLOBUCHAR, Minnesota
KIRSTEN GILLIBRAND, New York
MICHAEL BENNET, Colorado

SAXBY CHAMBLISS, Georgia
RICHARD G. LUGAR, Indiana
THAD COCHRAN, Mississippi
MITCH McCONNELL, Kentucky
PAT ROBERTS, Kansas
MIKE JOHANNIS, Nebraska
CHARLES E. GRASSLEY, Iowa
JOHN THUNE, South Dakota

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| Regulatory Reform and the Derivatives Market | 1 |

Thursday, June 4, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|---|
| Harkin, Hon. Tom, a U.S. Senator from the State of Iowa, Chairman, Committee on Agriculture, Nutrition, and Forestry | 1 |
| Chambliss, Hon. Saxby, a U.S. Senator from the State of Georgia | 3 |

Panel I

| | |
|---|---|
| Gensler, Gary, Chairman, Commodity Futures Trading Commission, Washington, DC | 7 |
|---|---|

Panel II

| | |
|--|----|
| Bookstaber, Richard, New York, New York | 34 |
| Dines, David, President, Cargill Risk Management, Hopkins, Minnesota | 36 |
| Driscoll, Daniel A., Executive Vice President and Chief Operating Officer, National Futures Association, Chicago, Illinois | 41 |
| Lenczowski, Mark, Managing Director, JPMorgan Chase & Co., Washington, DC | 31 |
| Masters, Michael W., Managing Member/Portfolio Manager, Masters Capital Management, LLC, St. Croix, U.S. Virgin Islands | 38 |
| Stout, Lynn A., Paul Hastings Professor of Corporate and Securities Law, University of California-Los Angeles, Los Angeles, California | 29 |

APPENDIX

| | |
|--|-----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 62 |
| Bookstaber, Richard | 64 |
| Dines, David | 71 |
| Driscoll, Daniel A. | 77 |
| Gensler, Gary | 80 |
| Lenczowski, Mark | 95 |
| Masters, Michael W. | 101 |
| Stout, Lynn A. | 131 |
| DOCUMENT(S) SUBMITTED FOR THE RECORD: | |
| Chambliss, Hon. Saxby: | |
| “Exchanges Warn On OTC Clearing”, article, <i>Financial Times</i> , June 3, 2009 | 138 |
| Dines, David: | |
| Chesapeake Energy, prepared statement | 139 |
| “The Role of Speculation in the Recent Commodity Price Boom (and Bust)” | 142 |
| Association for Financial Professionals, written statement | 177 |
| Commodity Markets Oversight Coalition, written statement | 179 |
| National Association of Manufacturers, written statement | 183 |

IV

| | Page |
|---|------|
| QUESTION AND ANSWER: | |
| Chambliss, Hon. Saxby: | |
| Written questions for Gary Gensler | 186 |
| Roberts, Hon. Pat: | |
| Written questions for Gary Gensler | 187 |
| Written questions for David Dines | 187 |
| Gensler, Gary: | |
| Written response to questions from Hon. Saxby Chambliss | 188 |
| Written response to questions from Hon. Pat Roberts | 189 |
| Dines, David: | |
| Written response to questions from Hon. Pat Roberts | 191 |

REGULATORY REFORM AND THE DERIVATIVES MARKET

Thursday, June 4, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 10:05 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Nelson, Casey, Klobuchar, Gillibrand, Bennet, Chambliss, Thune, and Johanns.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM THE STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman HARKIN. The Senate Committee on Agriculture, Nutrition, and Forestry will come to order regarding a hearing on regulatory reform in the derivatives markets.

Although we see hope in the strong economic recovery steps we have taken, we are still struggling through a grave economic downturn. The lack of sufficient regulatory authority and oversight regarding the financial markets is widely acknowledged as a key factor in the global economic crisis. It is not credible to assert that the markets and present regulatory system have worked. When the Federal Government has had to inject some \$4 trillion—\$4 trillion—into the system to stave off a total collapse of the economy.

Recent problems indicate the need for fundamental reform. Fundamental reform. The 2008 run-up in oil prices left our economy bruised, our Nation keenly aware of not only its dependence on foreign oil but the struggle with speculation in the markets. Volatile agricultural commodity prices, high input costs, and problems with the wheat and cotton markets have exposed vulnerabilities in our agriculture futures markets. But possibly the most problematic, our national economy has been held hostage by poorly regulated financial markets and the irresponsible behavior of some market participants, particularly when it comes to financial derivative products like credit default swaps and other over-the-counter derivatives.

I think it has become obvious that we must restore proper regulatory oversight if we are going to get this economy built on a solid foundation. Simply put, the derivatives markets must work properly and in the open. Agriculture futures markets are fundamental to the functioning of every aspect of our agriculture economy.

(1)

Financial services now account for about as much as 20 percent of our economy, and if those markets are not healthy or properly regulated, I think the evidence is clear our economy suffers.

Now, the Commodity Futures Trading Commission plays a vital role in providing oversight in keeping these players honest. If we do not invest in the regulators and the enforces to expand that oversight to the over-the-counter markets, I think we are going to continue to pay a heavy price.

It is imperative that we pass strong financial regulatory reform in this body and not just piecemeal, patchwork reform, but comprehensive and fundamental reform that brings full transportation and accountability back to the markets. Earlier this year, I introduced the Derivatives Trading Integrity Act; I think one I also introduced last year. The bill would require all futures contracts to trade on regulated exchanges. Why do I want that? Because exchange-traded contracts are subject to a level of transparency and oversight that is just not possible in over-the-counter markets.

For many years, derivative contracts have traded very efficiently and openly on regulated exchanges. But we have seen the damage done by moves to circumvent properly regulated derivatives trading.

I would also say it is not sufficient to assert, as many swap dealers do, that the market for credit default swaps function properly and has experienced no major problems during the current crisis. As conceived by derivatives traders in the mid-1990's at JPMorgan Chase—well, it was JP Morgan then—the CDS was designed to assist in the smooth functioning of the credit market and presumably to make it easier to raise capital by issuing corporate bonds to fund investment in the production of goods and services, which is what we want the financial sector to do. What is the end means of our financial services sector? That is for the production of goods and services to add to our GDP. Otherwise, you are just in a gambling game.

So the fact is it was going to make it easier to raise capital by issuing corporate bonds to fund investment in the production of goods and services. But the facts belie that claim. While the total face value of CDS contracts more than tripled—triple—between 2005 and 2008, the share of gross private domestic investment in U.S. GDP stagnated and then fell by more than 15 percent. That is at the end of 2008.

I have a chart. I wanted to see what it looked like, so I have a chart. So you see here the share of investment in U.S. GDP, and then here you have got on the red line the notional value of the CDSs.

Now, for a while, they seemed to track pretty well, but right here in about 2005, investment goes down and the value of the CDSs go up. So I think you can safely say they were not adding anything to the value of the goods and services of our country at some point in time.

Nor do I agree with those who assert that more rigorous regulation of these markets will discourage innovation or hamper our economy. Well, if financial innovation improves the ability of companies to hedge their risks or improves the functioning of the market, then the incentive for creativity will be there. But if the prime

motivation for innovation is to speculate, to avoid taxes, or assume reckless risks, the public has an interest in regulating that sort of "creativity."

I have often asked, Where was the market demand for credit default swaps? Where was the market demand for collateralized debt obligations? Where was the market demand for collateralized mortgage obligations? It was just sort of thought up.

You know, I have to digress here a second. I was just looking at the last issue of Newsweek magazine that has got Oprah on the front. I guess that sells the magazine. But it is called "The Revenge of the Nerd," and it is about the quants. How many people in this country know what a quant is and what they did in terms of speculation, through these mathematical geniuses that came from various and sundry place, how they devised these financial instruments to slice and dice and make money on things that really were not adding to the goods and services value of this country. It is a great article. I would recommend your reading it.

As I said, if that creativity is there just to add for speculation purposes and for sort of gambling and for high rollers and people making a lot of money in a short span of time, but not really adding to the sound investment in our country, then, quite frankly, I think the public has a big interest in regulating that kind of creativity.

So we must protect consumers and lower systemic risk and enhance the price discovery function of the markets, reduce excessive speculation, give the regulators the authority and information they need to keep the markets free of fraud and manipulation. In doing so, we will maximize the economic value of the derivatives markets by making sure they are structured to manage risk rather than to magnify it and guarantee that bad actors are held accountable.

So we have a lot of work to do on legislative reform. It is imperative that we all work together to come up with a solution that will bring transparency, accountability, and stability to our derivatives markets. So I welcome this hearing and this testimony. I thank each of the witnesses for coming here today, and I look forward to hearing their thoughts. I cannot think of anything that—well, this Committee has to do—we have to reauthorize the child nutrition bill later this year. We are going to work on that. But we have got to do this. This has got to be done this year.

I have talked with my colleague, my counterpart in the House, Chairman Peterson. He feels the same way. So I just do not think that we can push this off any longer. We have got to strengthen the hand of the Commodity Futures Trading Commission. We have got to give them the authority, and I am going to be asking the new Chairman about that and about any resources that they need. But we have got to get the CFTC the authority and the resources they need to do this kind of regulation and oversight.

With that, I will yield to my distinguished Ranking Member, my good friend, Saxby Chambliss.

**STATEMENT OF HON. SAXBY CHAMBLISS, A U.S. SENATOR
FROM THE STATE OF GEORGIA**

Senator CHAMBLISS. Well, thank you very much, Mr. Chairman, and you and I agree 100 percent that this is a critical issue, and

it is an issue that we have got to address and an issue that certainly calls for more regulatory measures, but I think regulatory measures that are not too intrusive to destroy markets rather than to continue to create and innovate in the markets. I know you had a conflict last night and were not able to be there, but we had a very good meeting with Secretary Geithner last night, along with our Senate Banking colleagues as well as our House Agriculture and Financial Services folks. We fully expect that the Secretary is going to come forward, I am sure with consultation of the new Chairman, with some recommendations in the next couple of weeks. We talked about some ideas that we have as policymakers there last night that are going to help influence, obviously, in a very strong way the direction in which the administration wants to go.

I am very confident that we are going to be able to come together with a very strong proposal that does make certain modifications that are not overburdensome, but yet at the same time will provide that protection that you referred to for all consumers as well as making sure that we have stability in the markets.

I do strongly believe that the Senate Agriculture Committee and the CFTC must be engaged in the development of any legislation addressing financial regulatory reform. This Committee has a responsibility to ensure proper oversight of the CFTC, and we must do more to fulfill this duty.

Today's hearing covers a wide range of issues: speculative trading in the commodities markets, changes to regulation of the over-the-counter derivatives, and the CFTC's authority over retail off-exchange transactions. Those are all worthy individually of hearings, and they are very complex issues that we are going to have to be dealing with in the legislative proposal that you alluded to and that I agree is going to have to come forward.

Among the most complex instruments, we have recently heard a great deal about credit default swaps, or CDS, which permit one party to transfer the credit risk of bonds or syndicated bank loans to another party. Given that AIG was heavily involved in CDS, it seems simple enough just to blame swaps in general for the current financial crisis. But, of course, it is much more complicated than that. Failing to distinguish between credit default swaps and the actual mortgage-related debt securities that these swaps were referencing has resulted in an oversimplification of the problem and subsequently an oversimplification of the proposed solutions.

Simply banning the use of all over-the-counter derivatives or forcing such contracts onto an exchange is unrealistic and unlikely to even address the underlying problem; that is, is this really a chance we are willing to take in these uncertain times, a chance that we would make things worse, dry up more capital, and force the cost of doing business higher?

Speaking of business functionally, curbing speculation is the physical commodity markets—speaking functionally, curbing speculation in the physical commodity markets is another area that we must approach very carefully. This is also not a simple topic. Determining how much speculation is necessary and how much speculation is excessive is an enormous challenge and something that we

will be talking with the Chairman as well as our other witnesses about this morning.

Some seem to have decided that all speculation is bad, but I would like to remind folks that without speculators in the marketplace, our farmers, ranchers, and energy users would find very little liquidity in these markets and would thereby not be able to utilize them effectively. Those individuals and businesses hedging risks and physical commodities, the parties that some claim they are trying to protect by running speculators from the market, are the ones who are likely to be hurt the most if speculative money dries up. I fear that this is another example in which oversimplification may be leading us to solutions of vast unintended consequences.

We must remember that during the past 18 months of bankruptcies, hailouts, and Government-assumed ownerships, the Nation's futures markets have functioned quite well. Price discovery has occurred, consumer funds have been protected, and there has not been a single bankruptcy of any clearing organization.

Does this mean there is not room for improvement? Of course not. Do I think the volatility in some markets over this lifetime warrants extensive analysis and possibly regulatory changes? Absolutely. While I may have concerns with some of the proposals that have been discussed relative to regulating both the use of over-the-counter derivatives and speculative trading, I am absolutely convinced that the market volatility and financial meltdown of the recent past make the case for more market transparency.

How can we in Congress gamble on the outcome of sweeping reforms without first properly identifying the cause of these problems? How can we identify the cause of the problem without authorizing and/or requiring more transparency through the collection of necessary data?

Yes, I have seen all the press accounts claiming the evils of indexed investments, swap dealers, and speculators, but what statistical data is used to support these claims? From what I can tell, many assumptions in the analysis to date are assumptions that may very well be accurate. But how do we verify this accuracy without access to the facts? Assumptions are simply not good enough when it comes to the responsibility Congress has to protect the integrity of these markets—integrity that would be compromised by lack of market liquidity or by increasing the cost of risk management or by forcing a migration of these markets overseas.

While I want to understand the causes that led us here, I do not believe anyone in this room—or anywhere else, frankly—has all the answers to what exactly went wrong. I am not willing to believe everything reported in the press unless the claims can be backed up with hard, verifiable data. To do otherwise is reckless. In fact, the data we have seen so far actually contradicts some of the claims people are so quick to believe and ultimately to blame for causing this mess that we are facing today.

Beyond requiring more transparency, I also believe this Committee should explore how most effectively to regulate swaps, some of which are statutorily excluded from CFTC regulation and oversight. We should review the manner in which hedge exemptions

from position limits are granted, and we need to determine how best to encourage the clearing of certain derivative products without jeopardizing either the use of these risk management tools or the sustainability of our clearinghouses.

If Congress is truly interested in addressing the problem as opposed to politicizing a solution, we can no longer ignore the complexities of these markets. We must devote time to understanding these instruments and their implications. We must seek to understand the legitimate purposes these complex instruments serve for large and small businesses in each of our States. That is why hearings such as this are absolutely essential. The last thing we should be doing is contributing a whole host of new, unappealing consequences in an already volatile marketplace.

Mr. Chairman, I particularly look forward today to hearing some of the practical aspects of utilization of these products that are on the market today, and I fully expect our witnesses to be able to tell us, No. 1, how they utilize them from the standpoint of making the economy of this country stronger by making their businesses stronger, and also how they think we can move in the direction of further regulation to ensure that confidence on the consumer side as well as stability and liquidity in the marketplace.

So, again, I thank you for bringing this matter forward. I know it will be the beginning of a dialog that fully recognizes the role of the CFTC but also that of the Agriculture Committee. I am very pleased that we have our new Chairman that we now have in place here to kick off this hearing this morning. Mr. Chairman, I say publicly congratulations and we are excited about you being where you are, and we look forward to working with you and hearing your testimony this morning.

Chairman HARKIN. Thank you very much, Senator Chambliss.

Now we will move to our witnesses, and first is our new Chairman of the Commodity Futures Trading Commission. Mr. Gary Gensler was sworn in as Chairman of the CFTC on May 26, 2009. Chairman Gensler previously served at the U.S. Department of the Treasury as Under Secretary of Domestic Finance and as Assistant Secretary for Financial Markets, subsequently served as a senior adviser to the Chairman of the U.S. Senate Banking Committee on the Sarbanes-Oxley Act reforming corporate responsibility, accounting, and securities laws. Chairman Gensler is the co-author of a book, "The Great Mutual Fund Trap"—which I just mentioned to him in private I have been reading parts of it, and I recommend it highly—which presents common-sense investment advice for middle-income Americans.

Mr. Gensler is a summa cum laude graduate from the University of Pennsylvania's Wharton School, with a Bachelor of Science in Economics, received a Master's of Business Administration from the Wharton School's graduate division in 1979.

Mr. Gensler, welcome back to the Committee. Congratulations again on your assumption of the chairmanship of the CFTC. Your statement will be made a part of the record in its entirety, and please proceed as you so desire.

**STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY
FUTURES TRADING COMMISSION, WASHINGTON, DC**

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, members of the Committee, thank you for your unanimous support in my recent confirmation, and thank you for inviting me here today to talk about this critical issue to the Nation's economy.

I believe that we must urgently enact broad reforms to regulate the over-the-counter derivatives marketplace. Such reforms must comprehensively regulate both the derivative dealers—those institutions that make markets in these products—as well as the markets themselves. I think that it is very important for the future of our economy and the welfare of the American people, and I pledge to work with this Committee and Congress to try to restore confidence in the financial regulatory system.

Many of these reforms will require statutory changes, of course, but, Senators, please also know that I have already directed the Commission staff to present all options under our current and existing authorities to protect market integrity and consumers from price volatility—that price volatility that may accompany a rebound in this overall economy as well, as we move forward. This is particularly the case within the physical commodities, whether it is wheat, grain, or energy markets.

A comprehensive regulatory framework governing the over-the-counter derivatives markets and over-the-counter derivatives dealers should apply to all dealers and all derivatives, and I believe that it should not matter what type of derivative is traded. That would include interest rate products, currency products, commodity products, equities, as well as credit default swaps, or that which cannot be foreseen yet, and any other swap or derivative product coming in the future.

Furthermore, it should apply to dealers in derivatives no matter whether they are trading in standardized products or in customized products. In my written testimony, I go further into that. But let me mention the four key objectives that I think we would wish to achieve here.

One is to lower systemic risk. We have to make sure that there is less risk in the overall system. Two is promoting transparency and efficiency in markets. Three is promoting market integrity and preventing fraud, manipulation and other abuses, setting position limits where appropriate. Fourth, protecting the retail public.

To achieve this, I foresee working with Congress on two complementary regimes: through the dealers that hold themselves out to the public in these products, we should set capital standards to lower risk margin requirements as they conduct business directly with other commercial enterprises; business conduct standards, which I want to return to; and recordkeeping and reporting. This would be for all derivatives, whether customized or standardized, whether they be interest rate product or credit default swaps.

On the dealer community, there are really just 20 or 30 large dealers, the business conduct standards would protect against fraud, manipulation, and other abuses. The recordkeeping and reporting, importantly, would allow the regulators to see a complete picture and aggregate this picture.

In addition, I do believe, though, we need to regulate the markets as well. This is a complementary regime to bring the standardized products, those products that can be brought into clearing and brought onto exchanges, further lowers risk. Clearing has the attribute that no longer would the financial system be so interconnected. Individual firms, rather than having exposures to each other, would have the clearinghouse that has to have the discipline of daily mark-to-market and daily posting of collateral.

Regulated exchanges and transparent regulated trading facilities or trading platforms bring additional transparency, and what we are proposing—and I believe the administration letter also spoke to this—is that there would be a real-time reporting of those transactions of the standardized products. So the full market could see on a real-time basis, as they do in the corporate bond market and they do in the securities market, the pricing of the products as clearly as they can.

Before I close this oral part, I want to say there are two other things, I think, that we need to work together on beyond regulating the over-the-counter derivatives marketplace and fully bringing this under regulation.

I believe that we will need to work together on the appropriate authorities to put in place aggregate position limits over the marketplace, particularly as it relates to physical commodity products, but also that we need to address some abuses in the retail area. Last year's fix with regard to foreign exchange trading, I think that we will need to extend that to other physical commodities. We thank you for some of those helps in Congress. Furthermore, to have clearer authority for the CFTC to make sure that foreign boards of trade comply with our transparency and position limit authorities here, effectively in statute to close what is called "the London loophole."

With that quick summary of a very complex subject, I look forward to working with this Committee and taking your questions today.

[The prepared statement of Mr. Gensler can be found on page 80 in the appendix.]

Chairman HARKIN. Thank you very much, Chairman Gensler, and as I said, I read your testimony thoroughly last evening, and I just found it very enlightening, and like I said, I think I agree with most of everything you have put in there. I have some questions I will ask about a couple of parts of it here. But as you know, I have expressed to you privately and I have expressed publicly that I appreciate, first of all, that this is the unanimous position of the Commission, as I understand. Is that right?

Mr. GENSLER. That is correct. I am pleased to report the testimony represents a Commission document.

Chairman HARKIN. I would be remiss if I did not recognize one of your Commissioners who is here, Michael Dunn, and to thank him for serving as the Interim Chairman of the CFTC during this period of time. I want to thank you very much, Commissioner Dunn, for doing that yeoman's work in that interim chairmanship.

You and I, Mr. Gensler, I think, agree on the need to enact significant regulatory reform—significant regulatory reform—of the derivatives market. I do not know if this is a divergence or not in

our approach, but it has to do with over-the-counter derivatives and whether they should be allowed to continue.

If we do allow over-the-counter trading, then I think the requirements that you have proposed would be at least the minimum, I think, of what we should be doing in terms of ensuring the integrity of those markets. But I just want to explore with you again on the record in public whether we might move all of this activity to a regulated exchange or an electronic trading system.

So I want to discuss that with you, but, again, I also want to get into what resources you might need also. I will not get into that in detail, but at some point we have got to think about what kind of resources you might need.

But you propose establishing criteria for determining whether a derivative is standardized or not. Now, I wrote these down: whether a contract is accepted for clearing by a regulated clearinghouse, the volume, the look alike nature of the contract, evaluating whether the difference between the OTC contract and the exchange contract are significant economically, or if the contract terms are disseminated to third parties. A lot of details are left out of that.

I still ask the question, I ask you as I asked it of Mr. Geithner, not before us but in a meeting in the Capitol: Define a "customized swap." What is a "customized swap" that cannot be traded on a regulated exchange? I still am wrestling with that.

Mr. GENSLER. Mr. Chairman, I think that we share your concern that we need to bring a regulatory regime to the entire market, those standardized and those tailored products, and that is why we are proposing to regulate the dealer community and be able to get the full picture, the full recordkeeping and reporting, even with an audit trail, so that we can police and enforce anti-fraud and anti-manipulation provisions, enforce position limit authority.

In terms of your question, we believe that there are tens of thousands of commercial interests in this country that promote their business needs by hedging within the futures marketplace and hedging within the swaps or over-the-counter derivatives marketplace. We need to bring regulation to that marketplace.

Individual commercial interests and municipalities sometimes want to tailor a product—it might be a specific product that hedges their risk in the interest rate markets, but it might be on a different day, it might be a different month than a standard product. Or it may be in the physical commodity market where it is an airline that wants a certain grade of jet fuel delivered at a certain location on a certain date. It is so specific and commercially even confidential that there is no liquidity, there are not four other parties that would do that exact contract.

So what we are proposing is that would still be regulated, it would still be regulated with regard to this first regime, where the dealers that are transacting this business have to comply with anti-fraud, anti-manipulation, that have to report and record all of this. The regulators would see a picture of the entire marketplace and be able to police that entire marketplace.

That commercial enterprise would get the benefit of transparency because the standardized products—over half the market, though it is hard to estimate exact figures, but a significant part of the market is standardized—would be brought into exchanges and re-

ported on a real-time basis, so the commercial enterprises get the benefit. But they may still want to tailor some features to a specific date or location in my little example that I gave.

Chairman HARKIN. I am still going to continue to press this issue, and I will with the other witnesses who come up. Give me an example of a customized, over-the-counter derivative contract that is so customized that it cannot be put on a regulated exchange.

Now, I understand that it may cost a little bit more for them to do that. But I think to me, the cost of that may eat into their profits a little bit. But to me, the need for the public to know that and for others to know it, for price discovery and transparency, it may be for a specific jet fuel, but that may have repercussions on other aspects of the oil market that could happen, depending upon how big that contract is.

So when you do that, I just have a hard time understanding what is so customized that it cannot be put out there in that market.

Mr. GENSLER. Mr. Chairman, the same reason that you are suggesting is why we think that even the tailored or customized products should be reported to the regulators so that the regulators can report the aggregate positions and see even the customized, in this case the example of the jet fuel. An exchange generally needs parties on both sides to come with bids and offers, and so really the key here is how much interest in a tailored product might there be.

So we believe we have to bring regulation to the entire marketplace, including these tailored products, and that we must have regulation of the dealer side so that we can also allow for commercial enterprises to still hedge their very specific and unique risks. At the same time, the commercial enterprises would be protected against fraud and manipulation. Market integrity would be protected by aggregate position limits across the markets. The regulators would be able to police these markets with seeing a real audit trail and a record of tailored and standard products.

Chairman HARKIN. On page 4 of your testimony—and I marked it last night—it says, “These standards”—regarding over-the-counter contracts—“also should require adherence to position limits established by the CFTC on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.” But if these contracts then are needed for price discovery, if you need price discovery, as you say right there, that “affect a significant price discovery function,” wouldn’t the public interest require this price discovery to be on an open, properly regulated exchange and not on the over-the-counter exchange?

Mr. GENSLER. Our proposal is that anything that could get onto clearing, anything a clearinghouse would accept for clearing would be presumptively standard. So if a clearinghouse accepts it, it would be considered standard. We will have to have rules of governance for these clearinghouses, and we have called for these to be fully regulated clearinghouses. But anything that was accepted should be out there and be exactly what you say, Mr. Chairman, fully transparent to the public and also on exchanges and on these trading platforms.

Chairman HARKIN. Well, there is some concern about the clearinghouses are run basically by the banks and others. This is not an open exchange. So I am concerned about what your regulation would mean and how we find out, again, whether these over-the-counter derivatives are being regulated.

Mr. GENSLER. I think the Chairman raises a very good point. Right now the clearinghouses, of course, have come into being—and, fortunately, they have come into being. There are a number of them that have started out. But they are on a voluntary basis. So we are talking about working with this Committee and Congress on having mandatory and statutory provisions. Working together we should find the right balance on governance as well with regard to these clearinghouses so we do not have, as you highlight, some of the conflicts that may exist. We would want to guard against those in the governance features.

Chairman HARKIN. Well, we will follow up on that. That is pretty interesting.

I am sorry. I took almost 10 minutes, so I will recognize other people for 10 minutes rather than 5-minute rounds. This is a very intricate subject, and it takes a little time to develop.

Senator CHAMBLISS.

Senator CHAMBLISS. Well, thank you, Mr. Chairman, and you are right, it is certainly above my brain's capacity to understand all the complexities of this industry. While you raise a good issue relative to customized swaps and derivatives, I think we are going to have some testimony from some folks today that actually use them, and they can dwell on the details. But I am pleased, Mr. Chairman, that you recognize that there is going to be a need for some custom items and products as we move forward.

We talked about this last night with Secretary Geithner, too, and he is of the same belief. It is the folks that are in the business every day that have the understanding of this rather than those who deal with so many other things on a daily basis.

Mr. Chairman, I sent a letter to—and let me compliment Former Acting Chairman Dunn for his great work, now Commissioner Dunn. We are pleased that obviously you were where you were and you are where you are, because it is folks like you and the current Chairman that understand these issues.

But I sent a letter back in April regarding several different issues, and you handed me the response this morning, so I am kind of going off what you just handed me here. But, basically, when we talk about costs, there are obviously issues on the trade side relative to costs, and we will talk more about that. But there are going to be significant costs on your side from the standpoint of whatever legislation we come up with, making further demands on you.

One thing I appreciate you going into detail about is if we are going to establish position limits and if we are going to make it mandatory upon the Commission to oversee and regulate items such as position limits, you have said that given the substantial increase in the number of commodities that would be required to have Federal speculative position limits, staff estimates that at least 20 full-time equivalent positions would be necessary to review the expanded scope of Federal position limits, grant hedge exemp-

tions, collect reports from persons granted hedge exemptions, and monitor for violations.

In addition, you go on to respond to my letter by talking about the further extension and regulation of speculative limits to OTC contracts and that also would be very significant and would require at least 60 additional staff, plus we would need to upgrade the systems that you have in place today to be able to handle that. Ballpark, do you have any idea what kind of additional funding we are looking for your budget to try to do just these things, which I think there is general agreement that we have got to move in this direction?

Mr. GENSLER. Senator Chambliss, I thank you for the letter that was sent to my predecessor and that I was able to deliver the estimates. The Commodity Futures Trading Commission, I believe, even with the generous support of this Committee and Congress is still sorely underresourced. We are in total at about 510 people. We just got authority to move up to 572, which just brings us back to the staffing levels that were in place in 1999, 10 years ago.

The futures markets that we regulate have gone up five-fold. The complexity has gone up significantly. We have six times more contracts today. But it is not just the number of contracts. It is global. We have gone from open outcry to electronic trading. So hopefully we will be working together with you and the appropriators in trying to find a way to address these very real resource needs.

If we do go further, as your letter asked about sitting more position limits, we made estimates of 20 or 60 people; you had two alternatives. Rather than speaking off the cuff, if we can get back to you on an exact sort of dollar figure that assigns to those two numbers, we would be glad to do that as follow-up.

Senator CHAMBLISS. Sure. Well, I think there is going to be general agreement that we have got to make some changes, and we agree here that you are underresourced now. But we are not going to put additional obligations on you without providing you additional funding. We are simply going to have to do that. Irrespective of what amount of money we are talking about, if, in fact, CDS or whatever part of the commodities market contributed to the financial collapse last year, it is going to be a lot cheaper to fund you to regulate than it will be to go through another situation that we are trying to recover from now.

Mr. GENSLER. Senator, I fully agree with you on that, that it would be a good investment of taxpayer dollars to guard against these risks.

Senator CHAMBLISS. One thing that has been of real concern to me from the standpoint of putting additional regulations in place is the fact that we might stymie, No. 1, innovation on the part of bright minds in the marketplace that are thinking of additional products, not just for the sake of making money on the end of selling them but providing a real service to businesses across our country and allowing them to utilize the marketplace, again, to offset risk.

If we, No. 1, take all the risk out of that, then I think we are going to be hampering the markets more so than helping them. Second, if we put in overburdensome regulations, then there is going to be the tendency of those folks, whether they are in my

hometown of Moultrie, Georgia, or Atlanta or New York, to simply go overseas and carry out the same transaction, but yet on another market that may not be regulated in the way we are talking about.

One thing that came up in our discussion last night—and I will not expect you to be able to talk in depth, but I would like your comment about this—is that if we are going to make changes to our markets in order to make sure that the same protections are in place for American consumers on overseas markets, then we need to go to our overseas markets, and we need to tell the Europeans that these are the changes we are going to make, and we hope you would look at the same type of regulatory process to try to coordinate and let us do not be overburdensome, but yet make the necessary changes so that our customers—or, excuse me, U.S. firm customers do not immediately go overseas and we lose that business and that ability to regulate those markets.

Any comments you have on the potential for that?

Mr. GENSLER. Senator, I think it is absolutely critical that we coordinate internationally with other regulators around the globe. Just yesterday, I actually met with the head of the European Commission on Internal Market and Services, Charlie McGreevy, on these matters. It was fortunate he was in town. But I know that Secretary Geithner and others are doing this. Commissioner Dunn is actually going overseas next week to take on some of this as well.

We need to coordinate and make sure there is not a race to the bottom somewhere else. I am encouraged by my meeting yesterday on that. I do think that we also have to really think about how we protect the American public and make sure that we get the right things in place there.

We need to not only allow but foster innovation so that the economy can grow but protect against risks, and the risks that we are talking about protecting against are the risk of fraud, the risk of manipulation, the risk that sometimes from speculation that becomes excessive speculation there may be burdens in terms of the volatility of markets. We are talking about protecting against the risk of unregulated actors like the affiliate of AIG, AIG Financial Products, that did not have any effective Federal regulation growing so large and being so excessively leveraged.

So while this is a complex proposal, regulating the dealers to lower risk, that means there is some capital. That means there is more cushion in the business that they have in their business model. That more capital may, as you suggest, lead to some more cost, but still allow for innovation, still allow fully for innovation, but lower the leverage in the system. I think one of the great lessons of the crisis of last year is the system overall, the financial system, got highly leveraged and too leveraged. Almost all the statistics will point to that.

So capital regimes and margin regimes lower risk; business conduct regimes lower the risk of fraud, manipulation, and the burdens of excessive speculation, but while still fostering innovation, fostering, as we have said in this approach, the allowance of tailored or customized products. So commercial interests can still hedge their risks.

Senator CHAMBLISS. I agree with you that certainly posting more capital is going to lower the risk, and I will not get you to go into any more detail than that because the other witnesses I expect will be able to give us some more information relative to that. But I want to make sure that we do not require too much in the way of reduction of risk that we just suck too much capital out of the marketplace and that we make sure that these folks that are utilizing whether it is over-the-counter or non-regulated today, that they still have the capital to operate their businesses in the way that they need to be operated.

I thank you, and I have got some more questions, but, Mr. Chairman, I will wait until the next round.

Chairman HARKIN. Thank you very much, Senator Chambliss.

The principle here we go on is time of arrival. Senator Casey was next, but he is not here right now. Then we will turn to Senator Johanns.

Senator JOHANNNS. Thank you, Mr. Chairman.

If I could maybe start out and do a little self-education here, because it is a hugely complicated topic we are talking about. But as I understand where you are kind of getting to here is, on the one hand, there is a set of regulations or an approach that you would like to be empowered to take relative to people or the companies that actually do business here. As I read the four items that you have mentioned, that really would deal with those dealers. Are we on the same page so far?

Mr. GENSLER. Yes, the dealers of which there are internationally maybe 20 or 30 large ones, they are out in the public domain, and by and large we know the names of those big financial institutions.

Senator JOHANNNS. Pretty straightforward working with them and laying out what the standards are going to be and the transparency and the capital that you have mentioned. So that for me is fairly understandable and fairly straightforward.

The second piece of this, though, I think it is really complicated, and that deals with regulation of products. How are you going to handle that, and what kind of authority do you want?

The first question I need to try to get an understanding about is as we look back over the last 8 to 10 to 12 months, if you were to identify the products that really were at the heart of the problem relative to the financial crisis, the AIGs, et cetera, what would those products have been?

Mr. GENSLER. Senator, I think that there are many factors that led to this economic and financial crisis, and only some of that was related to the products, because I do believe a great deal had to do with the excess leverage and excess borrowing and imbalances in the system overall. But in terms of specific products, I believe that the over-the-counter derivatives markets was a contributing factor, particularly with regard to credit default swaps explicitly. I think other products, if I can speak more expansively also, mortgage products specifically, the sales practices, and I think many homeowners and the retail public, often was misled, and even fraud in terms of the sale of those products, usually in the subprime market, but not always.

I think the securitized products, whether it is, as the Chairman mentioned, things called collateralized debt obligations and other

very sophisticated products there that are not specific discussions of this hearing today, because those are actually securities, and those are actually already regulated by the SEC.

I do believe the second regime is about bringing regulation to the markets, if I can use a term, rather than products. So it is bringing centralized clearing and a benefit of lowering risk that all of these derivatives or swaps come into a central counterparty and no longer is this interconnected web, but we try to have institutions use that central counterparty.

Some people say that we have had a system of too big to fail, but actually we have grown into a system that is also too interconnected to fail. So the central clearing is trying to make these counterparties less interconnected. You can think of it being less caught in a spider's web. The American public was caught in a spider's web of interconnected relationships last fall, and we should try to lower that as far as possible as we go and bring transparency to the exchanges.

Senator JOHANNIS. As I look at some of what happened—and you are right, gosh, picking out one thing is just not going to get you to an accurate viewpoint of what happened. But if I look at this—and hindsight is also 20/20. The amount of bad judgment exercised by people paid enormous amounts of money in salaries and bonuses is kind of breathtaking to me. How will what you are proposing protect the public from the exercise of that bad judgment?

Mr. GENSLER. Senator, I concur with you that there is a lot of bad judgment that went around. I think that at the heart, the way we protect the American public is having strict ability and clear, independent ability to protect the public against fraud and manipulation and the burdens that can come from excess speculation but also by putting in place this very real risk reduction, the capital and margin requirements both of the dealers and of the markets.

The American public should not be so at risk—they were terribly exposed by unregulated companies. AIG Financial Products basically was not regulated at the Federal level. Lehman Brothers and Bear Stearns derivative affiliates, basically lightly regulated at all at the Federal level. So we have to protect the American public. I believe this program, if enacted by Congress, would significantly do that with regard to over-the-counter derivatives. Certainly we need to do more about mortgage sales and some of these other areas that we talked about.

Senator JOHANNIS. Using AIG as an example, because what has happened to them is so very, very public, it was shocking to me to find out that they had this enormous risk exposure and basically no protect. If this thing started to implode, it was going to risk the viability of that entire company. You would have thought somebody would have paid attention.

If what you want to achieve here is accomplished, we give you the authorities that you are seeking, how would that have changed the situation with AIG, or would it have?

Mr. GENSLER. Well, I think that if these authorities were in place, and not just for this agency, the CFTC, but broadly, because of some of these authorities would be whether they be in a systemic regulator or elsewhere, to set capital, for instance—then AIG's Financial Products affiliate that did have, as you said—it was about

\$480 billion of credit default swaps. They would have had to have set capital to the side. They would have had to on a daily basis put aside margin and value those contracts. So as those contracts were going the other way, they would have been regulated.

I also think that while we have not studied it at the CFTC because we do not have any authorities over those products right now, but if you really look how the products were used and marketed, there is really in my mind some significant question about how they were marketed. They were largely marketed to lower capital standards in Europe and to be related to the products the Chairman talked about earlier, these collateralized debt obligations.

I think the credit default swaps have such unique features—a little bit like monoline insurance, a little bit like securities, they are certainly derivatives—that we are going to have to work together as regulators and with Congress to find some clear authorities on the trade practices with regard to credit default swaps.

Senator JOHANNIS. Thank you.

Mr. Chairman, thank you very much.

Chairman HARKIN. Thank you very much, Senator Johannis. That was an excellent question. That last one was great.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman. Thanks for holding the hearing. Chairman Gensler, thank you for being here. You are at the center of this storm and the historic run-up in commodity prices and oil prices last year that sort of caught everybody looking at how do we solve this, how do we prevent this in the future. It seems to me that the question is there clearly needs to be some kind of reform of the regulatory system that we have in this country with respect to a lot of these financial products that were sort of outside the realm of regulation. I guess the question is; how do we do this, what is the smart regulation? I am not someone who advocates regulation for regulation's sake. I think we have to think about how do we do this in a smart way, and it comes down to the fundamental question, in my view; how do we constrain risk?

It seems to me there are a number of ways that you could do that. You could have an exchange where there is more transparency and more accountability and where more of these transactions occur in the light of day. I think what happened was there was a lot of stuff that was going on in the dark.

Second, maybe it is in the form of margin requirements or capital standards, some of the things that you have alluded to, but I think we have to figure out how do we do that in a way that is responsible, that is smart, that gets at the heart of this problem, but does not push a lot of that capital to foreign exchanges, that does not create such an economic burden for a lot of the folks who are making markets in this country that they decide to go somewhere else to do it.

I think in order to make this work, it is critical, back to Senator Chambliss' questions, that we have international cooperation. So I guess my question is; how do we ensure that foreign exchanges are going to follow suit with the additional oversight and transparency regulations, specifically how do we go about doing that?

Mr. GENSLER. Senator, I share your view that this is about limiting risk, as you say, both in terms of the excess risk that you can limit through the capital and margin regimes, but also risks to the American public through protecting against fraud, manipulation, and other abuses.

I also share your view that we are going to need to and want to work with international regulators to see that there is not an arbitrage, meaning that people would go somewhere else rather than in these markets to avoid regulation.

I am encouraged by some of the initial conversations that I have had in my 8 days on the job. But I think that working with, the Chairman of the Federal Reserve and the Secretary of the Treasury, we are really going to have to work actively with our international colleagues to see that we can bring these reforms globally, and where there may be differences—because inevitably they have different political processes and legislative processes and regulatory processes—that we guard against those differences, not doing exactly what you said.

Senator THUNE. You have said throughout your testimony, you stressed the importance of protecting market participants from excessive speculation. I guess I am curious to sort of know how you define “excessive speculation.” We talked about the need for producers in States like Iowa and South Dakota to manage their risk. They use these markets for that purpose. But obviously speculation plays a role and did play a role, I think, in the problems that we encountered a year ago.

How do you define that, how do you get your arms around excessive speculation versus legitimate speculation?

Mr. GENSLER. The Senator asks a very good question. I share your view that financial investors, index funds, contributed and participated in the asset bubble of last year. I am concerned that as the good news of an economy that rebounds—and we hope, we all want this economy to rebound, that we might see a resurgence of these commodity prices. That is why I have already directed staff to really lay out for me as Chairman and for the Commission all the options that are available under current authorities to guard against this.

You know, Congress in the 1930’s, I believe, when they set up our predecessor, really best defined that. They said that there could be burdens to interstate commerce that come from excessive speculation, and Congress wrote into our statute that this could be unreasonable price fluctuations or the volatility that do not bear—I cannot remember the exact statutory words, but resemblance to the fundamentals.

Then Congress gave the Commission authorities to set position limits, and so it is through position limits that we try to guard against this, and we have actively used it over this time period.

Senator THUNE. Some have suggested that the CFTC and SEC ought to be merged into one regulatory body. What is your view on that?

Mr. GENSLER. Senator, I think whether we could have a debate here for a few days on what was the lead cause of this financial crisis, and I do not think any of us would put on the list that is near—I think we really have to focus for the American public on

lessons learned from this crisis, whether it is selling this product or this risk. So a merger for merger said to me while I think it will always be out there in the ether and be debated and discussed is not appropriate. I think we have a heavy agenda here working with Congress. Now, if somebody laid out why—if Congress and the President laid out why that would really help the American public, we would all want to work with that. But I do not see it really in the lead here of the reasons, and I do not think it is going to accomplish much for the American public today.

Senator THUNE. You got into a discussion earlier with the Chairman—and I think maybe with Senator Chambliss, too—about this distinction between standardized derivatives, customized derivatives, tailored derivatives, and the importance of having the ability for participants who enter into some sort of a customized association, that there would be a different way of regulating those. I guess the question comes back to is there a way of creating an exchange where these transactions could all be sort of managed in a way that is open and that is transparent and that allows for the public to be able to know what the pricing is and everything else.

What I heard you say was that you think it would be difficult to have that kind of a standardized—to create the sort of standardization of these products that would allow for them to be traded on some sort of an exchange, did I hear you correctly?

Mr. GENSLER. Well, Senator, I think that we can bring regulation—and it would be the identical regulation—to both tailored products and standardized products, identical regulation about protecting against fraud and manipulation, identical in terms of the capital charges of the dealer community, and we can even apply margin to both tailored products and standardized. The standardized products could have the margin through clearinghouses, and the tailored products could have it through the dealer community.

So I think actually it is a broad and very full regulatory regime—in fact, the same for tailored and standardized. What we need to encourage is much of the standardized product to be on centralized clearing because that continues to lower risk, and as much as possible onto exchanges or trading platforms, because that is an additional level of transparency, in addition to the transparency that the regulators will see it on, will aggregate it for the public, but additionally the standardized product, then you can see the real-time pricing.

It is a challenge. It is just a practical challenge. If it is tailored, you could put it on an exchange, and there would not be another party on the other side maybe. There might not be what is called a bid and an offer. So it is just a challenge. If we could do it, that additional transparency is helpful.

Senator THUNE. Well, I guess the bottom line is the transparency issue and price discovery, however those are regulated going into the future, that those elements be a part of any solution. So we look forward to working with you on this. Obviously, this is—it is a complex subject and one that many of us are trying to wrap our brains and arms around, and we appreciate your being here today and look forward to the testimony.

Mr. GENSLER. Senator, I thank you, and I look forward to working with you because I know these things are critical to your con-

stituents. We have to get everything to work in the wheat markets and the grain markets as well, and I know that has been a challenge, too, and we have got to focus on that.

Senator THUNE. I appreciate it.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Thune.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you very much for holding this hearing and for your persistence on all of these issues.

Mr. Chairman, welcome. It is nice to see you. I enjoyed reading your testimony. I wanted to focus on something that you have touched on lightly in some of your responses to the panel, because I think that the issues of the products, the issues of fraud, transparency, and all of that are important, and we need to make sure that we are doing a good job with these tough issues.

If you look back at where we are today and the cause of where we are, I think it is impossible to avoid coming to the conclusion that what ailed us most was the amount of leverage in our system. From the consumer level, if you look at credit card debt and home mortgage loans, to the Federal Government which doubled its national debt, to financial institutions on Wall Street that went from being 12 times levered to being 30 times levered over a period of time, you cannot sustain that unless you assume that you are going to have a hockey stick of growth for the rest of our lives—which is not going to happen.

I was struck in Lynn Stout's testimony—Professor Stout is here—when she wrote that her research indicated that the only time a significant U.S. derivatives market has not been subject to regulation was during the 8 years following the passage of the Commodity Futures Modernization Act of 2000. I was struck by that because I wondered as I read it how much that deregulation was a cause of the sheer volume of leverage in the market, because people were able to go out and create instruments, or whether they are unrelated. I wonder if you had a view on that.

Mr. GENSLER. Senator, I think you are correct that leverage in the American economy is one of the big causes of the crisis. If you just look at the overall statistics, it is remarkable, and I will just use it to summarize it. But through much of all of our lives, the economy has had a debt of about 1-1/2 to 2 times its economy. So it is like a household that might have a \$50,000 income and have \$75,000 to \$100,000 of debt.

We got up to about four times, about 4 to 1, and coincidentally, the last time we did that was in the late 1920's, the last time we got to that. These are the statistics published by the Federal Reserve on a quarterly basis.

I think that over-the-counter derivatives were a way that financial institutions—not the homeowners, but the financial institutions—add to their leverage as well, and that the capital and so forth were not charged there, and though I believe—looking back now it is clear to me that those of us involved earlier—and I served earlier—should have done more to protect the American public. Over-the-counter derivatives actually were not regulated even before that act passed in any way, for capital or for business conduct.

So what we are really talking about today, and working with Congress, is a full shift, because just as in the 1930's when President Roosevelt came to Congress and said we had to regulate the commodities markets and the securities markets for the first time, we are talking about—the CFTC, and I believe this is consistent with the administration, is talking about now coming and let's do this in a thoughtful but in a full way to regulate this market.

Senator BENNET. As you think about the systemic risk question, moving from a world where all of our regulation—that may be an overstatement—much of our regulation and all of our deregulation was, in effect, procyclical, was pushing us farther and farther and farther along this curve. How do imagine what you are proposing here will work with some of the suggestions that have been made by the administration, by the Fed, about where to locate the regulator of systemic risk? How will all these pieces fit together—your work, the Fed, the FDIC, the SEC? Because I think only if we have some way of looking at how these pieces fit together will we ever get the big picture. We can do it product by product by product, but really there is this big fundamental piece of not wanting to put ourselves in a position again where we simply have too much leverage on the economy and then have to go through an incredibly agonizing contraction, which is where we are today.

Mr. GENSLER. Right, right. I think that you are absolutely right, that we have had a lot of failures in our financial regulatory system; it failed the American public in the biggest test in 80 years. We have to address far more than just this over-the-counter derivatives marketplace, and part of that, as you say, Senator, is to have a systemic regulator, to have some ability for those largest systemically relevant institutions, those institutions that could make the public hurt so much, to have additional oversight.

I know that there are various approaches to it. What I would associate at least myself—I am not speaking for the Commission now, but just as Chair—is that we absolutely need this in working with Congress to make sure that it has clear authorities on those most systemically relevant. Those authorities might just be additional authorities.

So, for instance, where the CFTC is regulating markets and regulating clearing institutions and so forth, as a market regulator, I think in this country, again, since President Roosevelt and Congress worked together in the 1930's, market regulators have had their mandate, both the SEC and the CFTC, and that was a really important mandate, protecting the public, protecting the integrity of these markets, but then we would have a systemic regulator of some sort that we would have to coordinate.

Senator BENNET. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Bennet.

Now we go to Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman. Thank you for holding this hearing.

Mr. Chairman, it is nice to have you before us. I enjoyed our conversation earlier this year. I am interested in how we can find a way to regulate leverage, because leverage seems to be the operative word when you look at what happened with AIG. There was not a lack of leverage in their insurance operating subsidiaries be-

cause they are required by law and practice to put up reserves or capital against the commitments they made. But through the deregulation of 1988, I believe, with the decline of Glass-Steagall, with Gramm-Leach-Bliley, there was an effort then to be able to do as you chose at the top outside of the insurance operating subsidiaries.

Would you agree with that generally?

Mr. GENSLER. Senator Nelson, I believe with regard to AIG, they were regulated at the State level as an insurance company.

Senator NELSON. Exactly.

Mr. GENSLER. This has been a challenge, I know, for decades actually, and the Congress will probably want to take up in thinking about those systemically relevant firms, what if they are insurance companies and the relationship of Federal regulation to State regulation of insurance companies.

So I believe that AIG was sort of a case where there was an unregulated affiliate of an insurance company that was regulated at the State level. That unregulated affiliate, then it was sort of "Katy, bar the door."

Senator NELSON. Yes, and, in fact, the deregulation permitted this operation that was not regulated to do whatever it chose to do without setting aside capital to support the obligations it incurred.

Mr. GENSLER. Senator, I think that as it relates to AIG, which was not under any—in the 1980's, as you referred, not under, I believe back then, any Federal oversight. Later there was some, I would say, ineffective Federal oversight by the thrift supervisor. So I do not—I think really that it was an unregulated affiliate of an insurance company, and we have to make sure that going forward we regulate these derivative dealers, whether they are affiliated with an insurance company, whether they are affiliated with a hedge fund, affiliated with anything, if we are able to work with Congress and get this through.

Senator NELSON. Right, but that does not extend that somehow the Federal Government has to begin the process of regulating the insurance operating subsidiaries that are currently regulated by the States.

Mr. GENSLER. Not in this testimony or in my view. It is about trying to make sure that the derivative dealers come under a consistent regulatory oversight.

Senator NELSON. If they had the set-aside capital actuarially or in some fashion to support the obligations they were incurring, this would have been less likely to have happened the way that it has happened throughout the industry. Is that fair?

Mr. GENSLER. I think that is correct, Senator.

Senator NELSON. So establishing a way to require that capital will reduce the leverage that exists not only today but in the future as well. Is that fair, too?

Mr. GENSLER. I believe that is correct. I think to lower the leverage is setting those capital standards for the dealers, but also having margin posted, just as it is on a futures exchange. This has worked for decades in the futures exchange. There are problems even in regulated futures, but not about the capital and margining.

Senator NELSON. This was not related necessarily in every case to fraud, but in almost every instance you could say there certainly was some greed.

Mr. GENSLER. Well, I think that was the case broadly in this economic crisis.

Senator NELSON. I hope, as you look to regulate the tailored products as well as the standardized products, that there will be a system established to figure out the ratio for leverage against the obligations that are made. Do you believe you will be able to determine what the obligation is under tailored products?

Mr. GENSLER. I think, Senator, you raise a very good question, because one of the things about tailored products is they tend to be less liquid. They are sometimes harder to value.

Senator NELSON. There may or may not be much of a market for them.

Mr. GENSLER. There may not be much of a market, as the Chairman was talking about. I do think it is appropriate to take into consideration as regulators that if they are less liquid and they are tailored, that might lead to higher capital charges, just as any product that is less liquid and harder to value, because capital is meant to be a cushion against the risk if a firm fails or there are problems in the system.

So liquidity is a key, and just as the Chairman was talking earlier about whether the tailored products would be regulated, they would be consistently regulated; but if they are less liquid, it may be appropriate that the regulators say, well, you have to put a little bit more cushion aside on that.

Senator NELSON. Would you do this in the same way, let us say, that the National Association of Insurance Commissioners, which I used to head in a previous life, the way they do it through the Securities Valuation Office in New York that is part of the NAIC?

Mr. GENSLER. Senator, I dare say you are far more familiar with how that works. I am not familiar with the specifics there.

Senator NELSON. Well, they do value securities that do not have a market value based on one of the markets; in other words, private placements and the like. So tailored securities probably as much as standardized securities would fit into that sort of a category, where analysts would work their way through establishing what the leverage is, and then establishing capital requirements for that leverage.

Mr. GENSLER. I think, though I am not familiar with the specifics of that, I think that there should be consistently applied capital rules for the over-the-counter derivatives. Those that are on markets and those that are liquid, just like other products, the more liquid a product is, then—

Senator NELSON. The easier to value.

Mr. GENSLER. Easier to value, and it may necessitate a little less cushion, a little less margin. Certainly even in the futures markets right now there are different margins depending upon the volatility and liquidity.

I think one of the great lessons of this crisis is I believe that our overall capital regimes—and this is not within the CFTC, but our overall capital regimes let the American public down, and that we need to take, as Federal regulators, a closer look at those capital

regimes and make sure that they take into consideration particularly the less liquid instruments like collateralized debt obligations or structured product. Maybe they should have higher cushions or higher capital, and those that are easier to value, that are liquid instruments—

Senator NELSON. But you will have to have some mechanism, some way of—an analysis of establishing those values in an objective fashion, and I suppose you are going to be bothered by those that turn over too quickly to value them for any length of time, because you had them, they are gone, they have been sold. I just hope that you will find a way to consistently do that so that there is some objectivity and some reliability for establishing what the leverage requirements would be.

Mr. GENSLER. Right. Thank you, Senator.

Senator NELSON. Thank you, Mr. Chairman.

Mr. GENSLER. I thank you for your support.

Chairman HARKIN. Thank you, Senator Nelson.

Senator Gillibrand.

Senator GILLIBRAND. Thank you, Mr. Chairman, for holding this hearing, and thank you, Chairman Gensler, for being here and for testifying. These are very important issues. Few, if any, cities in the country have really felt the effects of the economic collapse more acutely than New York, New York City, the State that I represent. I want to talk to you a bit about how we can move forward so that we can create confidence in our markets and create a regulatory framework that will ensure success not only with the U.S. financial services industry but our economy overall, because we really do need to address the 8.5-percent employment rate nationwide, and we have to make sure our small businesses have the resources they need to grow and create jobs.

As we work to sustain the companies that form the backbone of our financial industry, we must ensure that the structures and the regulatory framework institute proper oversight and capital requirements while still promoting significant growth and expansion.

There has been a tremendous focus on the extraordinary losses that have resulted from the unregulated derivatives market, in particular the credit default swap markets, and rightly so. However, there also needs to be now significant attention paid to the regulation of these financial instruments, which have become an integral part of our financial system. We have to ensure that capital reporting requirements will allow derivatives to exist for legitimate participants, but discourage excessive speculation and protect our investors.

It is essential that we fully understand the implications on the end users, such as industrial companies who rely on derivatives to hedge commodity prices, interest rates, and foreign exchange rates. We must have an efficient and effective regulatory structure to ensure a vibrant economy, economic growth, adequate liquidity, and appropriate oversight and accountability.

So I first want to talk about what do you think and how do we allow legitimate participants versus those who are trying to game the system, and what sort of capital reporting requirements would allow custom derivatives to exist for legitimate purposes and par-

ticipants, but would discourage the excessive speculation and still be able to protect our investors.

Mr. GENSLER. Senator, if I might first start with thanking you for your support of my recent confirmation, and it is good to meet you. I lived in New York for 15 years. My three daughters were born in New York. Though I live in Maryland now, I have great affection and affinity for your State.

I think it is important to bring, as you say, greater regulation to this whole over-the-counter derivatives marketplace. I think we should best do that in two complementary regimes that would address, as you say, the legitimate interest of commercial parties to hedge their risks, but also have capital standards to lower the risk.

One is to have a regulatory regime of the dealer community—many that are in your great State—but of the dealer community so that those dealers have to have the capital to lower risk, to set margin, but also have business conduct standards to protect against fraud and manipulation. That regime covering the dealers would cover both standardized and tailored product. Tailored product or customized product would be allowed, but it would cover both of these as well.

I think that it is important, as you say, that commercial users have legitimate needs to do that, but we would want to bring as much of this product into centralized clearing and regulate the markets as well for that centralized clearing, because additionally that lowers risk. If we can lower risk through centralized clearing, that frees up capital in the dealer community, because if they can move product over to centralized clearing, that is a way to lower risk.

It also helps raise transparency to put that on exchanges where it is standardized product, and we would want to work with Congress to get this. So the presumption was if it could be on a centralized clearing, it could be on an exchange, we would do that.

Senator GILLIBRAND. What do you see at the upsides or downsides for actually requiring it to be on an exchange as opposed to just having it go through clearing?

Mr. GENSLER. We think that there are real benefits to also having it on an exchange. Of course, one of the features of our market system here in the U.S. is transparency, and the transparency of markets promotes economic efficiency. So we would have transparency by having information on 100 percent of the product, both tailored and standardized, available to the regulators. Making transactions available to the public lowers, we believe, some of the cost to the end users that you spoke about.

So bringing the standardized product onto exchanges means that any commercial user can see, Aha, 15 minutes ago, this is where—it might just be an interest rate swap, a standard product to hedge an interest rate for 5 years. They can see where that was. If you are a small hospital or municipality, you can say, Aha, that is where the pricing is and we should do the same.

Senator GILLIBRAND. But if you do require exchange trading, then you are really not going to have an opportunity for customized derivatives. So do you think you are going to lose enormous markets to overseas markets because you cannot accommodate that here?

Mr. GENSLER. Senator, we actually foresee that this approach would allow for, as you call it, customized or tailored product. Much of the derivatives marketplace right now is standardized, but there is still a very real need for end users to tailor their products.

So what we are calling for is 100 percent of the product, tailored and customized would be regulated through regulating the dealers. The product that could be brought onto exchanges would benefit because it would add transparency, but we would still foresee that end users would be allowed to tailor their needs. They might have a risk. I used earlier an example; it could be an airline that has a risk around a particular jet fuel to be delivered on a particular date in a particular location, that we would still allow for that, but still regulate and protect against fraud and manipulation and that the regulators would see it aggregated and publicly report the aggregated data.

Senator GILLIBRAND. I would like to turn specifically to one industry area, the trading of carbon permits, and the derivative products that may be based on them, and this may obviously become a major growth center for these markets.

How would these proposals affect the shape and the nature of carbon trading markets? Does the potential market for carbon derivatives have unique needs from other derivative products? What unique skills might the CFTC or another regulator need to effectively regulate this market?

Mr. GENSLER. Senator, I think that the CFTC has over many years developed a skill set and has a mission to oversee the derivatives marketplace, which we have called the "futures marketplace" for these years. In fact, there is already a small market in these permits or similar markets in Chicago called the Chicago Climate Exchange. There was a similar market that came up, oh, I think it is over 20 years ago now, out of some of the permits that came out of acid rain legislation of Congress.

As Congress moves forward and possibly further develops this, I would look forward to working with you and the Congress on how to get this right. But I think it would be important to protect against the same thing we protect against in the futures markets—fraud and manipulation. We should have the authority to set position limits, because these would be physically limited, these contracts would have a limited supply. So, again, hopefully bringing the same transparency and protections that we have currently to the futures markets.

Senator GILLIBRAND. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Gillibrand.

Now we will turn to Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much.

Mr. Gensler, you have had a long morning. It looks like I am the last one here for you. I just wanted to thank you again, and I am glad that you are joining us. I think I expressed my frustration last time at your predecessor when I asked about more tools that he could have in his job. He did not seem interested, and yet we saw at the time oil prices going up, due in part to speculation and other problems with the regulation of the market. I do believe—I appreciate what you said about transparency and that we need to also take steps to minimize speculation when it is done not to benefit

consumers or the market, but instead to benefit a certain small segment of those that are doing the trading.

We need an effective CFTC, and then we also need to do something about some of these instruments, financial instruments that cause some of this problem. Specifically, when I talked with you during your confirmation hearing, we talked about credit default swaps. Now that it is a little calmer here, I wondered if you could talk about what you think needs to be done to better regulate credit default swaps.

Mr. GENSLER. Senator, again, thank you for your support in my confirmation process.

I believe that we need to bring regulation to the entire over-the-counter derivatives marketplace, so credit default swaps but also the interest rate product, currency swaps, commodity swaps that this Committee certainly has talked a lot about in the last 2 years, and equity products.

I believe that we can best do that, as I was just saying with the Senator from New York, that we have a regime to regulate the dealers. There are internationally maybe 20 or 30 major dealers. I do not mean to limit them, but that work in these products. Many of regulated for other reasons, but we need to explicitly regulate them for business conduct, capital, margin, and reporting for credit default swaps and the products for tailored and standardized products.

I think second we need a regime that brings as much of the product as possible, the standardized product, into centralized clearing to lower risk. There are some voluntary features of that now, but we also need greater transparency through exchanges, while still recognizing there will be tailored and customized products that would be fully regulated in the first regime, but might not get the added risk reduction in the second regime and the added transparency in the second regime.

I think credit default swaps might have some unique features. In addition to what we have laid out in testimony today, I think the regulators, certainly the CFTC and the SEC working together, really have to consider additional features even with regard to credit default swaps, because they perform so many functions like securities.

Senator KLOBUCHAR. You mentioned the systemic risks. What do you think of this idea of having some kind of systemic risk regulator at the Federal Reserve or someplace that looked at the market as a whole?

Mr. GENSLER. Senator, I think that there are many lessons out of this crisis that developed in the last several years, but I think one of the lessons is that we need at the Federal level some clear authorities and mandates from Congress as to when a regulator can step in to protect against systemic risk.

All of the regulators, the CFTC included, primarily were put in place not to protect against systemic risk but to protect against very important risks to the public, but other risks. I think if Congress, working with the administration, moves forward, we should have a party or a mechanism such that the most relevant firms that could lead to crises might have additional standards and addi-

tional risk limitations to be less interconnected to protect the American public.

Senator KLOBUCHAR. As we head into the summer now—a lot of my constituents have cabins; this one is for them—they start to see the oil prices going up again. Why do you think oil is going up, what do you think we can best do to protect ourselves?

Mr. GENSLER. I think at the core of the mission of the Commodity Futures Trading Commission is to make sure that the markets are fair and orderly and that there is integrity. In the energy markets, I do believe that in the past asset run-up that financial institutions participated in that asset bubble. I think as this economy starts to recover—and we all hope for and are working hard for it to recover—that we will see some movement in commodity prices.

But I have said to the staff already—I have been there 8 days—that we have to look at every available option within our current authorities to see how we can protect the public and assure that there are not—as is our mandate, to make sure that there are not burdens from excessive speculation. And though it is not well defined in statute, it is a key mission of ours. I have asked for every option to be on the table, and I appreciate that as the summer moves forward, we might see more movement in these prices.

Senator KLOBUCHAR. Thank you.

Chairman HARKIN. Mr. Gensler, thank you very much for being here today and for your very open and frank discussion of these issues. It is very refreshing to have that kind of openness and just frank responses and answers. I appreciate it very, very much.

As we move ahead in this, we will be taking action this year, as I said at the beginning. We need your input to us on authority, which you just mentioned here; if there is additional authority that you need to carry out your mission, we need to know that, and what additional resources that you need to carry out some new responsibilities that I think that we may be giving you at the CFTC, charging you with. So we need to know that.

I know budgets are tight. I do not want to promise the sun, the moon, and the stars and everything like that. But I think the public is aware of the need for better regulation and whatever small amount of cost that might be I think will be more than outweighed by the public benefits that come through a better regulatory regime.

So we need to keep our lines of communication open on those two things—authority and resources. And I would yield to Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman, and I think all of my questions have been answered. I did want to make just one comment, though.

The Chairman as well as Secretary Geithner have both expressed, as we have talked about, this customized versus standardized transactions, that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing, and we talked about there are some clearinghouses out there now that are voluntarily accepting some of these transactions.

There was an interesting article in the Financial Times yesterday where three of these voluntary exchanges—the New York Ex-

change, the ICE Exchange, and the London Exchange—were warning Congress to be careful about this and careful about mandating and forcing too much of the over-the-counter derivatives into the clearinghouses, particularly because these tailored OTC derivatives being forced into clearinghouses that are ill equipped will really create a problem. And I would simply like to ask that a copy of that article be inserted into the record.

Chairman HARKIN. Without objection.

[The following information can be found on page 138 in the appendix.]

Chairman HARKIN. I could get into that, but we would probably get into a debate, and I do not mean to engender that right now. But I would say that I sat here in 1999 and 2000—I was not Chairman then, but I sat here and listened to all the reasons why we could not regulate. And I have the record. The question I asked of Mr. Greenspan when he sat here—not in this room—about the exposure and the regulation of these and what would happen if we did not do that. I am proud of the fact I am one of nine Members of the Senate who voted against deregulation of Glass-Steagall.

But I asked him that on the record, and I remember his answer. It is on the record. I have got it. He said do not worry—and I am paraphrasing. He said not to worry. He said these are smart people, and they will self-regulate because it is in everybody's interest to make sure that nobody else cheats.

Well, fooled once, your mistake. Fooled twice, my mistake.

Thank you very much, Mr. Gensler, for being here.

Mr. GENSLER. Thank you, Mr. Chairman. Thank you, Ranking Member Chambliss and members of the Committee. I look forward to working with you on this very important agenda for the American public.

Chairman HARKIN. I appreciate that very much, Mr. Gensler, and I want to thank the members of the Committee that showed up. I think this is one of the most important hearings that we are going to have this year. I thank the members of the Committee that showed up. I know everyone is busy around here, but I just cannot think of anything more vitally important that we are going to do this year than to address this issue.

Thank you very much, Mr. Gensler. Congratulations again.

We will call our second panel up; Ms. Lynn Stout, Professor at UCLA School of Law in Los Angeles, California; Mr. Mark Lenczowski—I hope I pronounced that right—Managing Director at JPMorgan Chase & Company; Dr. Richard Bookstaber, from New York; Mr. David Dines, President of Cargill Risk Management, and I will yield to Senator Klobuchar for purposes of introduction there; Mr. Michael Masters—oh, I understand he was traveling and evidently his connecting flight was canceled due to weather problems. He is on his way? OK.

Now Mr. Daniel Driscoll, Executive Vice President and Chief Operating Officer of the National Futures Association in Chicago.

If you will all take your seats, and, again, I would yield to Senator Klobuchar for the purposes of an introduction.

Senator KLOBUCHAR. Well, thank you very much, Mr. Chairman. I am just here to welcome Mr. Dines to the panel. He is from the Cargill Company, which is a very successful company located in

Minnesota, the biggest private company in the country. He was named President of Cargill Risk Management in April 1999. Cargill Risk Management is responsible for providing risk management products to producers, consumers, and investors in the agriculture and energy areas. He joined Cargill's Financial Markets Division in 1992, and in May 1994, he was asked to help start Cargill Risk Management, which is a new business venture for Cargill. And so we look forward to his words today.

Welcome to Washington.

Mr. DINES. Thank you, Senator Klobuchar. It is very nice to be here today. Thank you.

Chairman HARKIN. Well, we thank you all for being here. I know you have heard our interchange with Chairman Gensler. At the outset, I will say that all your statements will be made a part of the record in their entirety. I would like to ask if you could perhaps sum it up in 5 minutes, maybe, so we can have a round of questioning from the Senators.

I will just start in the order in which I introduced everyone, so we will start with Dr. Stout, and then we will move across the panel. Dr. Stout, please proceed. Welcome.

STATEMENT OF LYNN A. STOUT, PAUL HASTINGS PROFESSOR OF CORPORATE AND SECURITIES LAW, UNIVERSITY OF CALIFORNIA-LOS ANGELES, LOS ANGELES, CALIFORNIA

Ms. STOUT. Thank you, Mr. Chairman, thank you, members, for inviting me to testify today. My name is Lynn Stout. I am the Paul Hastings Professor of Corporate and Securities Law at the University of California at Los Angeles. My scholarly expertise actually includes the theory and the history of derivatives regulation. I also serve as an independent trustee of a large mutual fund that uses derivatives, so I have practical experience with the derivatives markets. And I have actually published several rather lengthy and, at the time to many people, I am sure, boring articles on derivatives regulation.

Please allow me to note that in these articles, which I published in the 1990's, I predicted that deregulating financial derivatives was likely to result in increased market risk, reduced investor returns, and price distortions and bubbles. I am as distressed as anyone that these predictions proved to be correct. However, I made the predictions because if you study the history and the theory of derivatives markets, you will inevitably reach four basic conclusions.

The first conclusion is that, despite industry claims—the industry seems to have a very short memory—derivatives are not new and they are not particularly innovative. There were derivative markets in the United States in the 19th century. Derivatives, of course, frequently go by many different names. The jargon that surrounds them is unnecessarily complicated. In the 19th century, however, they were called “difference contracts,” they were regulated by contract law.

I can cite to you the 1884 Supreme Court case of *Irwin v. Williar*, 110 U.S. 499, which essentially held that off-exchange derivatives were legally unenforceable unless the party entering the derivatives trade could prove they had a bonafide economic risk that they

were hedging against. So this is not a new issue, and the regulation of derivatives is not new.

Second, I can testify from my study of the history of derivatives that healthy economies regulate derivatives markets. This was true in Japan in the 15th century. It was true in the United States all the way up until the passage of the Commodities Futures Modernization Act of the year 2000.

Third, studying the theory of derivatives, it is true that derivatives trading can provide some economic benefits to the economy. Let me make a note. Clearly, derivatives trading can provide benefits to individual derivatives traders, just as gambling can provide benefits to individual gamblers. My focus—and I suspect the Committee's focus—is on the public good. And from the public's perspective, the primary economic benefit that you can get from derivatives trading is from risk hedging.

However, although the industry routinely claims that there are enormous risks hedging benefits, not to mention some offhand liquidity and price discovery benefits from derivatives trading, my research was unable to uncover any significant empirical evidence of the magnitude of these benefits. This is a claim I have been seeing be made by the industry for 20 years now. I thought I would update my research for this hearing.

They still have not generated any empirical evidence, any statistical evidence that demonstrates that the economic scope of these benefits is worth the costs that go along with them. And history teaches us that unregulated derivatives markets carry some very significant economic costs, including a very strong historical association with asset price bubbles, a very strong historical association with increased market risk and the failure of institutions. This goes back 500 years. We do not need to just focus on Orange County, Barings Bank, Long Term Capital, Enron, AIG, and Bear Stearns.

Third, derivatives regulation has historically been justified in part on the theory that encouraging speculation actually reduces economic productivity by diverting valuable resources, especially human creativity, time, and energy, away from more productive industries that contribute more to social welfare.

Fourth, derivatives trading is very clearly associated with increased levels of fraud and manipulation in the underlying markets.

Finally, the last lesson that the history of derivatives regulation can teach us is that successful derivatives trading regulation is possible and has been done. Generally, it has been accomplished quite successfully through a web of complex procedural rules that include reporting requirements, listing requirements, margin requirements, position limits—which I think are very important—insurable interest requirements, and limits on enforceability.

The joy of these rules is that they can be put in place *ex ante* so that derivatives traders know what is and is not required of them and can make plans. It does not call for excessive discretion on the part of an omniscient government regulator, and the rules are very time tested. They have done historically a very good job of permitting legitimate, socially beneficial derivatives trading for

risk hedging purposes while weeding out excessive speculation, excessive risk, and excessive manipulation.

If you will indulge me just briefly, I do think one thing that is really worth saying is people frequently discuss how complicated this issue is, and in the weeds, it is complicated. But the basic problem that we face from a policy perspective is actually quite simple. Although Wall Street surrounds derivatives with jargon, they are essentially one thing; they are a bet or a gamble on something that is going to happen in the future. And when I bet on a horse to win a race, my race ticket is my derivative contract. When I bet on the creditworthiness of a corporate borrower, my credit default swap is my derivative contract.

Betting can obviously be used to hedge against risk, so if I actually own a corporate bond and then I purchase a credit default swap, I have reduced my risk because if my bond goes down in value, my credit default swap goes up. But it is very important to recognize that derivatives can also be used and are especially attractive purely for speculative purposes. There actually is a clear economic definition of "speculation." It is trying to make money not by producing something or by providing investment funds to someone who is producing something, but instead by trying to predict the future better than someone else can.

As a practical matter, it can be difficult to establish that a particular derivatives trade is speculative in nature simply because traders are really good at making up alleged risks that they are supposedly hedging against. However, for 200 years, regulators have succeeded in coming up with ways to weed out true risk hedging from speculation, and this can be done, for example, at the macro level. I simply want to cite to you we may not know with exactitude which credit default swaps were exact hedges and which ones were speculation.

We can be quite certain by 2008 the CDS market was overwhelmed by speculation. We know this because the notional value of credit default swaps in 2008 was approximately \$67 trillion; whereas, the notional value of the bonds, both mortgage-backed bonds and corporate issue bonds that the credit default swaps were being written on, was less than one-fourth that size. It was \$15 trillion. When the derivatives markets is 4-1/2 times the size of the market for the underlying thing you are supposedly hedging the risk of, you know the market has been swamped by speculation with, I would say, sadly predictable results that we are now trying to sort through today.

So I think that is probably a good enough start.

[The prepared statement of Ms. Stout can be found on page 131 in the appendix.]

Chairman HARKIN. That is a great start. OK. Thank you, Dr. Stout.

We now turn to Mr. Lenczowski, Managing Director of JPMorgan Chase. Mr. Lenczowski.

**STATEMENT OF MARK LENCZOWSKI, MANAGING DIRECTOR,
JPMORGAN CHASE & CO., WASHINGTON, DC**

Mr. LENCZOWSKI. Thank you, Chairman Harkin, Ranking Member Chambliss, and members of the Committee. My name is Mark

Lenczowski, and I am a Managing Director and Assistant General Counsel at JPMorgan Chase & Co. Thank you for inviting me to testify at today's hearing.

For the past 30 years, American companies have used OTC derivatives to manage interest rate, currency, and commodity risk. Increasingly, many companies incur risk outside their core operations that, left unmanaged, would negatively affect their financial performance and possibly even their viability. In response to marketplace demand, financial products, such as futures contracts and OTC derivatives, were developed to enable companies to manage risk.

OTC derivatives have become a vital part of our economy. According to the most recent data, 92 percent of the largest American companies and over 50 percent of mid-sized companies use OTC products to hedge risk.

JPMorgan's role in the OTC derivatives market is to act as a financial intermediary. In much the same way financial institutions act as a go-between with investors seeking returns and borrowers seeking capital, we work with companies looking to manage their risks and with entities looking to take on those risks. Recently, clients, such as Chesapeake and Medtronic, have expressed great concern about the unintended consequences of recent policy proposals, particularly at a time when our economy remains fragile. In our view, the effect of forcing such companies to face an exchange or a clearinghouse would limit their ability to manage the risks they incur in operating their businesses and have negative financial consequences for them via increased collateral posting. These unintended consequences have the potential to harm an economic recovery.

Let me first discuss some of the benefits of OTC derivatives. Companies today demand customized solutions for risk management, and the OTC market provides them. Customization does not necessarily mean complexity. Rather, it means the ability to tailor every aspect of the transaction to the company's needs to ensure that the company is able to match its risks exactly.

For example, a typical OTC derivative transaction might involve a company that is borrowing in the loan market at a floating interest rate. To protect itself against the risk that interests rate will rise, the company will enter into an interest rate swap. These transactions generally enable the company to pay an amount tied to a fixed interest rate, and the financial institution will pay an amount tied to the floating rate of the loan. If rates rise steeply, they have some protection and can focus on their core operations.

OTC derivatives are used in a similar manner by a wide variety of companies seeking to manage volatile commodity prices and foreign exchange fluctuations.

In addition to customization, the other main benefit of OTC derivatives is flexibility with respect to the collateral that supports a derivative transaction. In the interest rate swap example, the financial institution may ask the company to provide credit support to mitigate the credit risk that it faces in entering into this transaction. Most often, that credit support comes in the same form as the collateral provided for the loan agreement. Thus, if the loan agreement is secured by property or equipment, that same collat-

eral would also be used to secure the interest rate swap. This collateral is high quality. It is the basis for the extension of credit in the loan agreement. As a result, the company does not have to incur additional costs in obtaining and administering credit support for the interest rate swap. This is a very significant benefit and without it, many companies will choose not to hedge their risks because they cannot afford to.

It is important to note that although derivatives currently are offered on U.S. exchanges, few companies use these exchange-traded contracts for two main reasons. Exchange-traded products are, by necessity, highly standardized and not customized. As a result, companies are unable to match the products that are offered on exchanges to their unique risks. Second, clearinghouse collateral requirements are onerous, and necessarily so. Clearinghouses require that participants pledge only liquid collateral such as cash or short-term Government securities to support their positions. However, companies need their most liquid assets for their working capital and investment purposes.

While we believe that exchanges play a valuable role in risk management, not all companies can or want to trade on an exchange. Currently, companies have the choice of entering into their hedging transactions on an exchange or in the OTC market. For most companies, OTC derivatives are critical to their risk management, and risk management is critical to their operations in volatile times. We believe that companies should continue to be allowed to have the choice to use these products.

This discussion of the benefits of OTC derivatives is not to deny that there have been problems with their use, and it is essential that policymakers examine the causes of the financial crisis to ensure it is never repeated. We have noticed reports in the press that derivatives dealers are working to avoid regulation. This is absolutely wrong. The efforts that have been reported on are part of a 4-year effort with regulators to enhance practice in the OTC derivatives market. The latest letter is just the last quarterly submission outlining our efforts to enhance market practice.

To that end, we propose the following, which is consistent with the administration's position and Chairman Gensler's testimony today.

First, financial regulation should be considered on the basis of function not form.

Second, a systemic risk regulator should oversee all systemically significant financial institutions and their activities.

Third, all standardized OTC derivatives transactions between major market participants should be cleared through a regulated clearinghouse.

Lastly, enhanced reporting requirements should apply to all OTC derivatives transactions.

JPMorgan is committed to working with Congress, regulators, and other industry participants to ensure that an appropriate regulatory framework for derivatives is implemented. I appreciate the opportunity to testify, and I look forward to your questions. Thank you.

[The prepared statement of Mr. Lenczowski can be found on page 95 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Lenczowski.
Now we turn to Dr. Richard Bookstaber. Dr. Bookstaber.

STATEMENT OF RICHARD BOOKSTABER, NEW YORK, NEW YORK

Mr. BOOKSTABER. Mr. Chairman and members of the Committee, I thank you for the opportunity to testify today. My name is Richard Bookstaber. During my career I have worked extensively in risk management, and I was also one of the pioneers in the development of derivative products on Wall Street. I am the author of the book "A Demon of Our Own Design; Markets, Hedge Funds, and the Perils of Financial Innovation." That book, published in April of 2007, warned of the potential for financial crisis from derivatives and other innovative products. Although I have had extensive experience in both investment banks and hedge funds, I come before the Committee in an unaffiliated capacity and represent no industry interests.

My testimony will focus on reducing complexity and increasing transparency in the derivatives markets through standardization and exchange trading. Derivative instruments—and I use the term to include options, swaps, and structured products—can improve financial markets. They can allow investors to mold returns to meet their investment objectives, to more precisely meet the contingencies of the markets. They can isolate and package risks to facilitate risk sharing.

However, derivatives also can be used for far less lofty purposes, like allowing firms to lever when they are not supposed to lever; take exposure in markets where they are not supposed to take exposure; and avoid taxes that they are supposed to pay. In short, derivatives are the weapon of choice for gaming the system. These objectives are best accomplished by designing derivatives that are complex and, thus, opaque so that the gaming will not be readily apparent.

Such complexity, as I point out in my book, makes the financial markets crisis prone. Complexity hides risks and creates unexpected linkages between markets. Because derivatives are the primary source of this complexity, to reduce the risk of crisis we must address the derivatives markets. We need a flight to simplicity.

The proposed centralized clearing corporation, while a welcome step, is not sufficient to do this. It may address counterparty concerns, but it will not sufficiently address issues related to standardization, transparency, price discovery, and liquidity. To do that, we need to have standardized derivative products and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in transparency and efficiency, and it will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivatives-induced complexity creates.

Now, one stated objection to standardization and exchange trading is that having some products out in the light of day will only increase the demand for the more shadowy and opaque products. Another objection is that the push toward standardization will reduce innovation. These concerns lead to demands by some to abol-

ish all OTC derivatives and by others to shrink from exchange trading. There is no need to move toward either of these two extremes. We can have a combination of standardized exchange-traded instruments along with the continued development of customized OTC instruments.

Abolishing OTC derivatives is not wise. There will be legitimate reasons for customized derivatives and no doubt innovations will emerge with broad value to the financial markets. The point is not to stifle innovation but to assure it is directed toward an economic rather than a gaming end.

Standardized exchange-traded derivatives will create a hurdle for any nonstandard over-the-counter product. The over-the-counter product will have worse counterparty characteristics, be less liquid, have a higher spread, and have inferior price discovery. To overcome these disadvantages, the nonstandard OTC product will have to demonstrate substantial improvements in meeting investment needs compared to the standardized product. Also, and importantly, stricter controls can be placed on nonstandard OTC derivatives. For example, the regulator may mandate the disclosure of OTC positions and require a demonstration of why they are being used instead of a standard product.

While there will still be the opportunity for innovation and for the application of the more complex derivatives, I believe that for most legitimate purposes the standardized products will be found to be adequate.

Now, financial institutions might have to be pulled less than willingly into any initiative to standardize derivatives or to move derivatives from over-the-counter onto an exchange. They have an incentive to keep derivatives over-the-counter and not standardized. For the bank, the more complex the instrument, the greater the chance the bank can price in a profit for the simple reason that investors will not be able to readily determine the fair value. And if the bank creates a customized product, then it can charge a higher spread when an investor comes back to trade out of the product.

For the trader, the more complex the instrument, the more leeway he has because it will be harder for the bank to measure his risk and price his book. And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic gaming objectives they might have in mind.

In conclusion, we should move toward standardization and exchange trading of derivatives. And we should do this because it is the reasonable direction to go, not as a reaction to the current crisis and not predicated on whether derivatives were the villains of this crisis or merely innocent bystanders.

The argument for standardization and exchange trading of derivatives is compelling. But there remains much we do not know. Therefore, it is important to move slowly, learning by doing rather than pushing for quick, wholesale solutions.

There are markets that are beyond the purview of the CFTC, indeed that are beyond our horders, so the natural pace will be a gradual one.

Thank you for the opportunity to provide this testimony, and I look forward to your questions.

[The prepared statement of Mr. Bookstaber can be found on page 64 in the appendix.]

Chairman HARKIN. Thank you very much, Dr. Bookstaber.

Now we turn to Mr. David Dines, President of Cargill Risk Management. Mr. Dines, welcome.

**STATEMENT OF DAVID DINES, PRESIDENT, CARGILL RISK
MANAGEMENT, HOPKINS, MINNESOTA**

Mr. DINES. Thank you, Mr. Chairman. My name is David Dines, President of Cargill Risk Management. I am testifying on behalf of Cargill, Incorporated, and I want to thank you for the opportunity to be here today.

Cargill is an extensive end user of derivatives and relies heavily upon efficient, competitive, and well-functioning futures and over-the-counter markets. One of the major challenges for policymakers and regulators is that the term "over-the-counter" covers a vast array of products across a number of markets. This broad definition highlights why it is extremely difficult to seek a one-size-fits-all regulatory or legislative solution that still allows all interested parties to manage or hedge their genuine economic risks.

One major concern with the recent proposal by the Treasury Department is that it appears to seek a regulatory solution for all OTC products in response to systemic risk posed by one particular market; credit default swaps.

It is important to note that while we have witnessed the greatest economic crisis in 80 years, OTC contracts in the agriculture, energy, and foreign exchange markets performed well, did not create systemic risks, and, in fact, helped many end users manage and hedge their risks during this very difficult time.

In today's hearing, we will focus our comments on three of the four objectives of the recent Treasury proposal. We support the stated objectives and believe that steps could be taken to meet these goals, without denying end users' access to an effective and competitive market.

The Treasury Department's first objective is to prevent activities in the OTC markets from posing risk to the financial system. The outline seeks to apply mandatory clearing of all standardized products and impose robust margin requirements to meet this objective.

The imposition of mandatory clearing and mandatory margining of tailored hedges will have a significant drain on working capital. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital requirements.

The potential magnitude of this drain on working capital should be carefully weighed by all policymakers. I would like to submit for the record a letter from the National Association of Manufacturers as well as a recent letter from Chesapeake Energy, an Oklahoma-based end user of OTC derivatives and the largest independent producer of natural gas. The Chesapeake Energy letter provides an excellent example of how imposing mandatory margining could severely drain capital that could otherwise be invested to grow a business.

[The following information can be found on page 139 in the appendix.]

Mr. DINES. In the one example provided here, over \$6 billion would have been taken away from running and expanding a job-creating business, and instead be left idle in a margin account until the maturation of the OTC contract—a contract which had already been secured with collateral. Expand this example across all businesses that use OTC products and the amount of capital diverted from growing the U.S. economy would be severe, unless companies reduced their hedging and risk management.

There is a misconception that OTC products do not have credit provisions and are never collateralized or margined. A significant number of OTC transactions are collateralized, margined, or make use of credit agreements to secure the contract with collateral being moved daily to adjust for the change in market value.

With regard to mandatory clearing of standardized products, defining which products are “standard” and which products are “customized” is a complex issue that must be thoroughly examined by the appropriate Federal regulator to avoid disrupting market segments that continue to perform well.

The loss of tailored hedging tools will also greatly impact the ability of companies to comply with current accounting standards. The Treasury Department outline also indicates that substantial capital requirements could be placed on all OTC dealers.

There is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers. The agriculture and energy hedging sectors have active non-financial institution OTC dealers who offer healthy competition in the market, and it would be inappropriate to eliminate these competitors from the OTC market through legislative or regulatory action.

To meet the Treasury Department’s first objective of protecting the financial system, regulatory requirements should be risk based and not one size fits all. Additional monitoring and transparency is warranted; however, restricting working capital through major increases in mandatory margining in these markets is counter-productive.

Objective 2: The Treasury Department’s outline seeks to impose more recordkeeping and force trades onto regulated exchanges to promote efficiency and transparency within the OTC markets. We recommend more recordkeeping and better disclosure, although the regulator should be directed to focus on areas with the greatest risks. As previously mentioned, mandatory movement of activities from the OTC market to an exchange-traded market does not seem warranted in those markets that have not created systemic risks to the financial system.

Objective 3: The Treasury Department’s outline seeks clear authority to police fraud and market manipulation and the authority to set position limits on OTC derivatives. Cargill recently filed comments with the CFTC on a proposed rulemaking that addresses this objective where we support position limits for non-commercials, much greater transparency and reporting for over-the-counter markets, and we offered detailed suggestions for implementation.

In summary, Cargill recommends that additional legislative and regulatory actions in the OTC market are risk based and not treat all products identically; seek to add minimal costs and disruptions

to those products that have not posed systemic risk to the financial system.

Two, mandatory clearing and margining would severely reduce hedging activity, would greatly restrict working capital at a time when it is in very short supply, and is not warranted for OTC products that have not created systemic risk.

Third, the CFTC, through its existing rulemaking, is proposing much needed steps and should continue to work on ensuring the enforcement of position limits in related exchange-traded markets, principally agriculture and energy products, and improving transparency and reporting of OTC products.

We appreciate the opportunity to testify today and look forward to working with the members of the Senate Agriculture Committee and other policymakers as this issue develops. Thank you.

[The prepared statement of Mr. Dines can be found on page 71 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Dines.

Now we will turn to Mr. Michael Masters. You did show up.

Mr. MASTERS. Coming from the West Coast.

Chairman HARKIN. I understand you took an overnight flight.

Mr. MASTERS. Yes, I had a little trouble getting here with the thunderstorms last night.

Chairman HARKIN. Welcome, Mr. Masters, of Masters Capital Management, and as I said earlier, your statements will be made a part of the record in their entirety, and please, if you would take 5 to 7 minutes or something like that, I would appreciate it very much.

Mr. MASTERS. Sure.

Chairman HARKIN. Thank you, Mr. Masters.

**STATEMENT OF MICHAEL W. MASTERS, MANAGING MEMBER/
PORTFOLIO MANAGER, MASTERS CAPITAL MANAGEMENT,
LLC, ST. CROIX, U.S. VIRGIN ISLANDS**

Mr. MASTERS. Thank you. Good morning, Chairman Harkin and members of this Committee. The derivatives markets present Congress with two very critical and very distinct problems; systemic risk and excessive speculation.

Last fall, the world financial system teetered on the brink of collapse. This near-meltdown had a catastrophic effect on our Nation's economy, causing the loss of trillions of dollars in retirement savings and millions of American jobs. At the peak in 2008, the notional amount of over-the-counter derivatives outstanding totaled over two-thirds of a quadrillion dollars. These positions formed an interlocking spider web of enormous exposures amongst the 20 to 30 largest swaps dealers and represented an extreme amount of leverage since very little margin collateral backed up these huge bets.

This unregulated shadow banking system was effectively destroyed in the fall of 2008. It threatened to destroy the regulated financial system with it. However, regulators pumped trillions of dollars into the shadow banking system to allow OTC derivatives dealers to make each other whole on their bets. This was necessary to prevent a domino effect of dealer collapses that would have destroyed the world's financial system.

Congress owes it to the American people to ensure that this never happens again. The risk of a financial system collapse must be eliminated, not regulated. Everyone agrees that clearing needs to take place in order to increase the transparency of these markets. But not all clearing is created equal. This clearing process must include two important provisions.

First, clearing must involve novation wherein the derivatives clearing organization becomes the central counterparty to both sides of the trade. This will eliminate the interlocking spider web of exposures among swaps dealers because every dealer's exposure will be to the central counterparty and not to each other.

Secondly, clearing must involve daily margin where every day the central counterparty collects margin payments from those dealers whose bets are going against them. This ensures we never have another AIG.

If this system had been in place in 2008, then it would have been virtually impossible for the financial system to melt down.

Wall Street will seek to block mandatory exchange clearing by arguing that swaps are highly customized and cannot clear. This is false. The standard that regulators should adopt is not one of standardization versus customization, but one of clearable versus non-clearable. Chairman Gensler said during his confirmation hearing that if an OTC derivative can clear, then it should clear. Treasury Secretary Geithner said if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and, thus, required to be cleared. This is the right standard and will result in a vast majority of swaps clearing through an exchange. Exchange clearing will lead to price transparency, tighter bid-ask spreads, and greatly reduced cost for end users of the swap markets. There will also be greater liquidity due to lower trading cost and reduced emphasis on credit concerns.

Now let us look at excessive speculation. America experienced a bubble in food and energy prices during 2008. This was caused by excessive speculation in the derivatives market for these commodities. These markets have become dominated by speculators, and prices no longer reflect supply and demand.

Now, in 2009, the problem is once again raising its ugly head. Today, the supply of crude oil in the U.S. is near a 20-year high, while the demand is near a 10-year low, according to the IEA. Yet the price of oil has risen an amazing 85 percent this year, from the mid-30's to the mid-60's. There has been a chorus of voices from oil market participants, economists, and even OPEC squarely pinning the blame on speculators for unjustifiably driving oil prices higher. If Congress allows this to continue, then high oil prices threaten to throw our economy back into the double-dip recession and potentially ruin the Obama stimulus.

Your constituents are flat on their backs financially and will not tolerate gasoline prices rising to \$3 or \$4 again. The excessive speculation problem can be eliminated by imposing aggregate speculative position limits. These limits must cover all trading venues which will require closing all the existing loopholes to ensure that every venue is regulated equally.

The swaps loophole is an exemption granted by the CFTC which gives swaps dealers free rein to buy and sell commodity futures in unlimited quantities. The best way to close it is to mandate that all OTC commodity derivatives clear through an exchange. This needs to happen to eliminate systemic risk, but it also needs to happen so that regulators can actually apply position limits. When a swap clears, the exchange breaks that transaction into component parts and becomes the center counterparty to both sides of the trade. This enables regulators to see both sides and enforce aggregate speculative position limits.

The London loophole occurs when foreign hoards of trade are permitted to trade contracts that are virtually identical to U.S. futures contracts. The solution is simple, foreign exchanges must be required to supply all the same data that designated contract markets provide to the CFTC, and they must enforce speculative position limits.

Right now, the possibility for cross-border regulatory coordination is at an all-time high. G-8 Ministers issued a statement last week along with OPEC calling for greater regulation to crack down on excessive speculation in the energy markets.

The CFTC must set the limits for all consumable commodities, not the exchanges. Speculative position limits should be set for the commodity as a whole rather than one particular grade or delivery or location, for instance, crude oil, not just West Texas Intermediate. Speculative position limits need to be aggregated across trading venues.

In summary, the best way to eliminate the risk of another financial system collapse is to mandate that all OTC derivatives clear through an exchange with a novation and daily margin. And the best way to prevent another bubble of excessive speculation is to make aggregate speculative position limits apply across all trading venues.

The CFTC has 70-plus years of experience regulating exchange clearing and policing markets for excessive speculation. The SEC and Federal Reserve have little to no experience in these two key areas. In fact, the SEC has allowed passive commodity investments in ETFs, ETNs, and commodity mutual funds.

They have signed off on double-leveraged crude oil EFTs like the DXO that allow any investor to make leveraged speculative bets in crude oil within their retirement accounts. This does not show good judgment from a consumer protection or a market protection standpoint. For these reasons, the CFTC is the best and most appropriate regulator for the job.

Thank you. I look forward to your questions.

[The prepared statement of Mr. Masters can be found on page 101 in the appendix.]

Chairman HARKIN. Well, thank you very much, Mr. Masters, for summarizing a very extensive statement you had here, which I read last night, which I found extremely interesting.

Now we turn to our final person here. This is Mr. Daniel Driscoll, Executive Vice President and Chief Operating Officer of the National Futures Association. Mr. Driscoll, welcome.

STATEMENT OF DANIEL A. DRISCOLL, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. DRISCOLL. Thank you very much, Chairman Harkin, Ranking Member Chambliss, and all the members of the Committee for allowing us to participate here and to ask you to close a loophole where fraudsters are able to offer over-the-counter derivative contracts to the retail public.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry, and we also regulate over-the-counter retail forex products. NFA is first and foremost a customer protection organization, and we take that mandate very seriously.

Now, the other witnesses today have talked primarily about OTC derivative products that are offered to and traded by large, sophisticated institutions. But I am here to tell you that there is also a growing aspect of the OTC derivatives markets that is directed toward the retail public, and those customers are being victimized in a totally unregulated environment.

Now, for many years, retail participants in the futures markets have enjoyed all of the benefits of the Commodity Exchange Act. Their contracts were traded on regulated exchanges and cleared by regulated clearing organizations. Their brokers had to meet the fitness standards of the Act and were regulated by the CFTC and NFA. However, today, there are too many customers that do not receive any of the benefits of regulation, and we need to do something about that.

The main problem stems from a court case often referred to as the Zelener case, which was a Seventh Circuit Court of Appeals Case involving a CFTC enforcement case alleging forex fraud. In that case, the district court ruled that the customers were, in fact, defrauded but that the CFTC did not have jurisdiction because the contracts were not futures contracts.

In that particular case, the contracts were offered to the retail public for speculative purposes. They were rolled over and over again so that delivery never took place. Basically they were the functional equivalent of a futures contract.

Unfortunately, the Seventh Circuit ignored those characteristics and ruled that the written contract itself should determine the nature of the contract, and because the contract did not guarantee a right of offset, they ruled that they were not futures contracts, and the CFTC lost that particular case. There were other courts that followed the Zelener decision and came up with similar rulings over the next several years.

Last year, Congress closed the forex loophole but, unfortunately, the loophole is not limited to forex so that customers dealing in other OTC products, such as gold and silver, are still in a regulatory mine field, and we need to bring regulatory protections to those customers as well.

Back in 2007, NFA predicted that if Congress plugged the Zelener loophole for forex but left it open for other products, the fraudsters would simply move over to Zelener-type contracts in other commodities, and that is exactly what has happened. Now, we cannot quantify the exact numbers of that fraud because these firms are not regulated and are not registered. But we are aware

of dozens of firms that offer Zelener contracts in metals and energy.

Recently, we received a call from a man who lost over \$600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints and mounting customer losses involving these products since Congress closed the loophole for forex.

NFA and the exchanges have previously proposed a fix which would close the Zelener loophole for these non-forex products. Our proposal codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*, which was the accepted state of the law until Zelener. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts unless delivery is made within 7 days or the retail customer has a commercial use for the commodity. This presumption is flexible and could be overcome by showing that delivery actually occurred or that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements.

This statutory presumption would not cover securities and banking products, it would not interfere with inter-bank currency markets, and it would not cover the retail forex contracts that are already covered or exempt under Section 2(c). I would also say that our proposal would not invalidate a 1985 interpretive letter issued by the CFTC, which Monex and other similar firms currently rely on to sell gold and silver to their clients. Essentially, that letter set forth a factual pattern which culminated in the actual delivery of the precious metals within 7 days and title to those metals going over to the retail customer so that it would not be covered under our statutory proposal.

In conclusion, while we support Congress' efforts to deal with systemic risk and create greater transparency in the OTC markets, Congress should not forget that there is a very real risk to the retail public participating in another segment of these markets. The Committee can play a leading role in protecting customers from the unregulated boiler rooms that are currently taking advantage of the Zelener loophole for metals and energy products. We look forward to further reviewing our proposal with Committee members and staff and working with you on this important matter.

Thank you.

[The prepared statement of Mr. Driscoll can be found on page 77 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Driscoll. Thank you all for your testimony. I cannot help, Mr. Driscoll, but to comment upon your statement. I offered an amendment on the last farm bill to close Zelener. We passed it in the Senate.

Mr. DRISCOLL. Yes, thank you very much.

Chairman HARKIN. Well, we did it, and we went to conference and lost it in conference. All we were able to keep out of that was just the forex contracts that you are talking about. Again, I think that was a mistake, and I said so at the time. But it did not have the votes. So I am glad to hear your testimony again today calling for a broader closure of the Zelener loophole that the Seventh Circuit opened up for everybody. It went beyond currency, and they

applied it to everything else. So I appreciate your comments today, and hopefully maybe if we move some legislation this year, we can also finally close that loophole.

Mr. DRISCOLL. Thank you, Senator Harkin.

Chairman HARKIN. I just could not help but comment on that.

It seems like everyone here is basically saying that there is a legitimate need for derivatives trading, I think, if I am not mistaken, but that it would be well regulated, transparent, but there is some need for some liquidity in the marketplace that might be provided by that. I am reminded of what one person said to me, a Congressman said to me, a former Congressman said to me one time about liquidity. He said, "You know, liquidity is good, but too much liquidity can be bad." He said, "It is like I take an aspirin every day. My doctor says I should take an aspirin every day for liquidity. But if I took a whole bottle every day, it might be kind of dangerous to my health." So I have often thought about that kind of analogy.

I also think about the analogy that Dr. Bill Black testified to last fall when we had our first hearing on this. Someone had commented upon, well, we do not want to stifle the free flow of capital, to which Dr. Black responded, "Well, I do not know," he said, "if we really want the free flow of capital; maybe we want the more efficient flow of capital." And he used the analogy of traffic flow.

He said, "You know, if we want the free flow of traffic, do away with all the stop lights. Do away with the stop signs. Do away with the speed limit signs. You will have a very free flow of traffic. But you are going to have a lot of wrecks." And he analogized that to the financial markets, that we need regulation, we need the stop lights and the slow-down signs and the danger signs and things like that, not so much for the free flow of capital, but for the more efficient flow of capital.

Now, with that as a backdrop, I understand the need for liquidity. I also appreciate, Dr. Stout, your testimony. A lot of this gets clouded in jargon. We say, oh, this is complex and all that. But it kind of boils down to certain essentials all the time. And I will start here with what Mr. Lenczowski testified to, and that is that many banks relied on credit default swaps instead of fully meeting capital requirements.

So we have heard a lot of discussion here about, well, we should not have to come up with capital requirements too much. I think maybe Mr. Dines maybe testified to that; I think maybe somebody else did, that requiring too much capital requirements might stifle the transactions and the more open flow of capital and hedging. But many banks relied on these credit default swaps instead of meeting the capital requirements under the Basel II rules—I had to learn this, too, what Basel II was—thus contributing to the buildup of excessive leverage and risk.

So I guess a question for all of you basically is this; how do we control the risk to the financial system and our broader economy when institutions rely on derivatives too much and we do not have as much capital coming forward? So that is really what we are trying to wrestle with here.

Now, again, I will make another statement as sort of a backdrop to what I am getting at here. There have been a couple of articles in the Wall Street Journal and New York Times recently, and they

concluded that the banks and other over-the-counter swaps dealers oppose certain reforms for the basic reason that the greater transparency and disclosure involved in exchange trading would impair their ability to make profits. That is, if the parties on the other side of transactions had a better idea of what prevailing prices are for swaps, then the banks and swap dealers would not be able to charge as much as they can if they kept them off the exchange, in the dark and out of sight.

I want to state emphatically I am not opposed to the financial sector making profits. They have done very well in the last few years, I might note, but I think there is also a countervailing tremendous public interest at stake here. When we have to come up with \$4 trillion to rescue the economy, a bill that we will be paying and our kids and our grandkids will be paying for some time, then I think it argues that we have to balance this desire for making profits, which is fine, with the countervailing balance of the public interest here.

So I do not see this as a really complex issue. What it basically is, on the one hand we have the public interest in protecting the economy from these risks; on the other hand, the quest of the financial sector to make maximum profits. And to me that is just how I see it. It is not much more complex than that. And as I delved more into derivatives and credit default swaps, I then found out that all these things, whether they are credit default swaps, collateralized debt obligations, collateralized mortgage obligations, all these things, hardly any of those existed before 1990. Most of them came up in the 1990's.

I keep asking the question; where was the demand? Where was the demand for these products? I found out there really was not any, just that these quants that I referred to earlier came up with ingenious ways of slicing and dicing all these little derivatives, these tranches, and no one really knew what the value of them was.

I have often said jokingly that I never knew when I was growing up that someday I would need Honey Nut Cheerios. I thought Cheerios was just fine. But all of a sudden, I found out I need Honey Nut Cheerios. Well, that is OK. I do not mind that. That is an innovation. They were able to sell that, no one is hurt, that is fine. But if innovation in this financial sector does not pertain to some underlying value or benefit to the goods and services of the GDP, then it just seems to me to beg for more regulation and oversight.

I did not mean to go on so long on that, but if I had a basic question for all of you, and I will just go down the line; how do we balance this off? How do we provide for liquidity, the aspirin a day but not a bottle a day? How do we provide for innovation that might pertain to underlying value, but not innovation that just allows someone to gamble and make a lot of money, and keep our markets regulated in the public interest, how do we balance those off?

Dr. Stout.

Ms. STOUT. I think that history gives us some very good guidelines because we actually did that pretty well between 1933 and 1934 and the mid-1990's. And I think the legislation that you are pro-

posing, which in many ways reinstates some of those old-fashioned, time-tested, highly successful strategies, is a very good start.

I want to just point out, it is interesting, Simon Johnson of the MIT Sloan School has estimated that between 1973 and 1985, the finance sector of the U.S. economy accounted for 16 percent of corporate profits, and that in the last decade that has increased to 41 percent of all corporate profits were earned by the finance industry.

Although I do not have the exact breakdown, I suspect that many of those profits were actually trading profits earned by hedge funds and by the proprietary divisions of investment banks. Where did they come from? I will simply point out that hedge funds were earning between 10 and 20 percent annual returns over the last decade. Average investors, who are my investors—I am a trustee of a mutual fund; that is the Moms and the Pops who buy our mutual fund interests—they got 3 to 4 percent a year. I do not think that you can assume that is a coincidence.

Chairman HARKIN. Mr. Lenczowski, how do we balance these?

Mr. LENCZOWSKI. Well, first, thank you, again, Chairman, for allowing me to testify. I think first I would to state that at JPMorgan we broadly support the initiatives of the administration and of Chairman Gensler to undertake regulatory reform.

Chairman HARKIN. By the way, I would be remiss if I did not compliment JPMorgan because you are the ones back in the 1990's that did not get involved in that credit default swap mess. And I think you were very prescient on that, so I would be remiss if I did not compliment you on that.

Mr. LENCZOWSKI. On behalf of our institution, thank you.

But to go back to the points you were making, Chairman Harkin, the first thing on capital, and I think just to state as a bank we are subject to very stringent capital requirements already, and I think, if I might, the capital that Mr. Dines was referring to and perhaps Senator Chambliss referred to earlier, we are talking about capital that is coming out of non-banks, out of the end users, the companies in our country that create jobs. And if they were to trade on exchange—which they currently have the right to do, but if they were to be forced to trade on an exchange, they would have to take capital out of their corporations and pledge it to the exchange. That is the way the exchange operates.

So when we talk about a drain on capital, it is not our capital. It is the capital of companies like Cargill, Chesapeake, and they told you how much that would be. It is billions of dollars.

The other point I would make, Chairman Harkin, on demand, the history of the over-the-counter business has been one that has grown in response to customer demand from the relaxation or the dropping of the gold standard in the 1970's and responses to oil price shocks and inflation led to unprecedented volatility in currency rates, in interest rates. This is what led to the interest rate and currency markets to grow, to serve customer needs. These are markets that exist to serve customers, and we serve as a financial intermediary.

You mentioned CDOs. In the early part of this decade, we had a time of very, very low interest rates, of investors looking for enhanced yield and willing to take on extra risk. And the CDO market, the CMO market, and many other structured markets arose in

response to the investor demand for higher yield with higher risk. We have seen what has happened as a result of the collapse in real estate prices.

Last, I would just close, this part at least, by saying that, again, we support clearing. It is an important tool that we currently use. We derive great benefits from it, from credit risk reduction and an operational standpoint, but we think it would be a mistake to impose that kind of a one-size-fits-all requirement on our economy.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. I would disagree to some extent with the last statement. I believe that there is a component of the development of "innovative products" that is very much along the lines of what you, Mr. Chairman, depicted, where the banks or investment banks realize that if they can differentiate themselves, that if they are selling something that other people are not selling, and if it is sufficiently complex, they can price it in a way that people will have difficulty understanding if it is fairly priced or not, and they will be able to trade it with a higher spread because the client does not have many other avenues for trading. So liquidity basically is a negative aspect and complexity is a positive aspect when it comes to profit for the bank or the investment bank.

On the other side, as I think you also pointed out, part of the investor demand that has come for some innovative products has occurred along the "Hey, I got a problem" sort of approach; that is, somebody is trying to say, "You know, I want to lever but I am not allowed to lever. Can you help me out here?" And on that basis, you get new innovations that are helping for these gaming purposes.

I believe that there is a need for innovation, that we can have innovation, but regulators need to, No. 1, find a means to have innovation that is directed toward economic purposes as opposed to gaming purposes. And I do not know the proper method for doing that. I think that it is clear that we need to have capital, margin, haircuts, whatever sort of method is used, to back derivatives and other exposures rather than having them be off balance sheet without sufficient capital background.

I agree also with one point that Mr. Dines said, that it is reasonable to have a distinction between different types of products, though not on the basis of what caused a problem in the past versus what did not, because we do not want to drive through the rearview mirror. But there are some products in some markets that inherently are more systemic by nature. Interest rates and currencies are just by nature going to be more systemic than corn, wheat, and commodities of that type. So we more urgently need to have the ability in those markets to control and to aggregate so that we can detect patterns of crowding that may move us from having an issue where it becomes systemic because many firms are all on the same side of the boat.

Chairman HARKIN. Thank you very much, Dr. Bookstaber.

Mr. Dines.

Mr. DINES. Thank you. I guess I would start by just confirming what was said by the other panelists, and what I said in my testimony is that we, again, do not believe that you can take a one-size-fits-all approach to solving this. The regulatory changes that apply

to credit default swaps may not be and I do not think are appropriate for the energy and agricultural markets. We believe that there should be greater transparency and reporting to the regulators, and we have said that we think that there should be position limits for non-commercials.

We believe that this will go a long ways toward solving the issues. We do not think that mandatory margining and clearing is necessary, and we think that will have unintended consequences of reducing people's hedging, companies' hedging, and that will cause significant risks.

Chairman HARKIN. Unless I misinterpreted what you said, Mr. Dines, you are basically proposing that we separate financials out from commodities.

Mr. DINES. I am saying that we need to take a different approach to these different segments, and what might be appropriate for credit default swaps may not be appropriate for the energy and agriculture markets. I think some do have more systemic type risks than others.

Chairman HARKIN. Yes, I understand.

Mr. DINES. OK. Thank you.

Chairman HARKIN. Mr. Masters.

Mr. MASTERS. Thank you, Senator. I think there are two parts to the question. One is liquidity and one is innovation.

First of all, let us just get out the word "innovation." Innovation is a word that Wall Street uses to talk about anything they do in the financial markets. Innovation by itself has sort of a positive connotation when people think about innovation. But innovation is not always good. You know, Ford had the Edsel. There have been many, many products developed in our economy over the last few hundred years that were not good products. Why is it that everything that Wall Street creates is a good product? There are a lot of bad products. So I would just like to get that out to begin with.

In fact, I would argue that since many of these innovative products affect consumers in a very direct and a very real way, including loss of jobs, savings, and so forth, where is the financial FDA for this? You know, who is looking at what the aftereffects of these products are? Because it is certainly not Wall Street. They are just looking at their bottom line.

With regard to innovation itself, the exchanges themselves have produced plenty of innovation as well. It has not just come from the over-the-counter market.

So, at any rate, I would just like to get that out, but with regard to liquidity, one of the things that some of the folks that have testified have mentioned is the whole issue on financing cost for corporations, and what many may not realize is that those financing costs are borne by someone. When you buy a swap from someone, the other side of that swap, if it is a large investment bank, those funds are not free.

So all that financing cost that people say, oh, we are going to have financing cost and margin and so forth, you are already paying that if you are an over-the-counter customer to a bank. You just may not see it. In addition, you are paying other things that you may not see, notably, profit margins.

So the issue that we argue with regard to mandatory clearing for standardized derivatives is—I think you would actually lower the costs because you would have more people that would be able to trade with each other with regard to swaps. You would increase the liquidity. You would certainly lower the bid and offer. And so I actually think that, contrary to raising costs for corporations, you would actually lower costs for corporations ultimately.

We had that experiment with the New York Stock Exchange when bid offers went from eighths to quarters and halves to decimals, and volume has tripled and liquidity has tripled. So I think you look at that example and you have a better idea of really what the future could be, and you have many, many more participants in the market, not just investment banks, that are allowing liquidity.

Chairman HARKIN. Excellent point. Thank you.

Mr. Driscoll.

Mr. DRISCOLL. Chairman Harkin, I have been a futures regulator for almost 40 years, and I can tell you that when I first started out—this is sort of the flip side of the innovation angle—there were no such things as interest rate products in the futures markets; there were no stock index products. The whole panoply of products out there that I think everyone, without exception, agrees are very valuable, not only to the futures markets but to the participants in the futures markets and to the American and the worldwide economies. So there obviously is a plus side to innovation.

From the regulatory standpoint, I believe that it is key that all of these markets be subject to a prudent level of regulation. It does not mean that every market has to have exactly the same regulations. Equity securities and futures do not have exactly the same types of regulations. And I think the focus on systemic risk and transparency by Congress, the administration, and the CFTC is exactly the right one.

I am a big proponent of clearing organizations and exchange-traded markets. That is primarily what we regulate. So anything that can be done to encourage moving as much business as feasible onto regulated markets and to have those instruments cleared would be a positive thing, recognizing that I am—and I am not the biggest expert in that area—that I am sure that there are any number of more non-standardized products that would be difficult to put on an exchange.

Thank you.

Chairman HARKIN. Thank you all very much. I took an inordinate amount of time with that, but I yield to my friend Senator Chambliss.

Senator CHAMBLISS. Let me start with you, Mr. Lenczowski. You mentioned in your written testimony that the industry is seeking to clear more credit default swaps. Would you expand on other ongoing efforts to curb systemwide risks relative to CDS in addition to the clearing?

Mr. LENCZOWSKI. Yes, thank you, Senator. Over the past 4 years, the dealers have been working with investors to come up with market improvements for the credit default swap market, and several of those improvements have been made. First, the amount of undocumented trades has been drastically reduced. There have been

protocols agreed as to the way to treat novations or transfers of trades. There has been a huge improvement in the amount of trades that are electronically confirmed, which significantly decreases operational cost.

Then just recently, there has been a major change and restructuring of the way that the market operates so as to standardize cash settlement as the form of settlement of credit derivatives and to standardize all economic terms, essentially, for credit default swaps.

The result is that the product has become standardized to the point where we think that more and more over-the-counter credit default swaps will be cleared. The ICE U.S. Trust Clearinghouse started operation earlier this year already clears over \$800 billion of CDS transactions. That number is going to grow. Old trades are being backlogged into the system to further increase the pervasiveness of clearing. So the entire progression of the market has been toward increasing clearing, increasing transparency, additional recordkeeping and transparency from the standpoint of pricing, prices are now available on the Internet, freely accessible for the largest entities that are traded.

So it has been a steady progress working between dealers and investors, working with the regulators to improve the market.

Senator CHAMBLISS. Does your firm use the ICE OTC clearing?

Mr. LENCZOWSKI. Yes, we do.

Senator CHAMBLISS. How is that working from a practical standpoint?

Mr. LENCZOWSKI. It has been working very well. Again, clearing is distinctly in our interest to do. When the transactions are standardized and when counterparties to our transactions are able to clear, we derive great benefits from clearing. And we have used the ICE clearinghouse for credit default swap clearing, and we also use other clearinghouses for other asset classes. So, for example, in the interest rate swap market, we use the London clearinghouse called LCH Clearnet, which clears a huge volume of interest rate derivative transactions. Something like 50 percent currently of the dealer-to-dealer swaps are cleared. And in the commodity markets, we are clearing through facilities operated both by ICE and by the CME group called ClearPort.

So all this evidence is a move toward clearing. We think it is—amongst the dealers, it is definitely in the interest of everyone to reduce risk, to increase transparency.

Senator CHAMBLISS. There seems to be a perception out there that the only derivatives that need to be customized are the very complex and most complex products. Are there not simple foreign currency or interest rates swaps that still need to be customized for your clients?

Mr. LENCZOWSKI. Yes, absolutely. And actually Chairman Gensler earlier described one of those transactions, a simple interest rate swap which has been around now for almost 30 years, is very well understood, not a complicated transaction at all. But it is extremely customized as to every economic term, and that is to give the end user, the company that is entering into that swap, the maximum hedge for its risks, and also to get the best accounting treatment. An entire accounting framework has grown up around

derivative transactions and hedging transactions, and over-the-counter instruments are the best way for companies to take advantage of that accounting framework.

There is another example I could cite. Chairman Harkin was looking for examples of why something has to be done over the counter. In the natural gas markets, at this point dozens of public utilities engage in long-term natural gas purchase contracts where they are able to procure natural gas at prices below the prevailing market price on a monthly basis for the next 15 to 20 years. These are very long term purchase contracts, and they are able to do that through the use of over-the-counter natural gas and interest rate derivatives. These are contracts that ultimately benefit millions of consumers of natural gas, customers of these utilities. They are well understood. They are approved through the Tax Code amendments passed in 2005, and they serve an incredible benefit to communities throughout the U.S.

Senator CHAMBLISS. There has been a lot of conversation and critique of the markets over the past year with respect to what is called "excessive speculation," and that speculators drove up the physical commodities to record high prices. Now, you deal in the market on a daily basis, I assume sometimes as a speculator, sometimes not. Explain what you see with respect to speculation, why it is necessary and what is happening with regard to this issue of excessive speculation.

Mr. LENCZOWSKI. Yes, Senator. And I might preface it by first saying that we strongly support efforts to combat and prosecute manipulation. Market manipulation is in no one's interest, and certainly from a market participant standpoint, it is extremely detrimental to all of our activities. And—

Senator CHAMBLISS. Obviously, there is a difference between manipulation and speculation.

Mr. LENCZOWSKI. Yes, and speculation is necessary for markets to perform. To take a very basic example, the farmers of this country, when they farm grain, will need to sell it ultimately to bakeries, for example. The baker and the farmer need to match up, one to sell grain, the other to purchase grain. The chances of them matching exactly for all of their purchases are extremely low. Speculators expand each side of that market. They buy and they sell. And they provide the liquidity that is necessary for markets to operate. So all markets require some degree of speculation. Excessive speculation certainly is something to be combated, and we would support that.

Senator CHAMBLISS. Mr. Dines, you deal in the markets every day with respect to risk management tools that you use in your business. I would like for you to give us a practical example of one of these customized contracts that you use. And if those customized contracts were not available to you at Cargill, what effect would that have on your business?

Mr. DINES. Happy to do so. Thank you.

Everyone here knows that Cargill is a processor of corn, and we are in the markets buying corn every day. In essence, we are buying corn at the average price over a given period since we are in buying it every day.

The best hedge for us if we wanted to protect against prices going higher would be a product against the average, not a product against a discrete point in time, which is what you can get on the exchange.

We can go into the OTC markets and buy what is known as an average price option. An average price option comes at a 30-to 40-percent discount to what is available on the exchange. It is a more precise hedge for what we need because it is against the average. It is real cost savings up front, and this cost savings might be the difference between what gets us to hedge and what does not get us to hedge. So that is a real example.

Now, we cannot go in and buy that product on the exchanges. Average price options do not exist. Furthermore, in the OTC markets, we can tailor that product to give us the exact level of protection that we want and for the exact end date that we want. Let us say that we wanted to do it on new crop corn, but we only wanted to go through the pollination period of July. If we went to the exchange, we would have to buy a product that ends in November. We could tailor this product to end in July. We are saving ourselves 4 months of time value of extra cost that goes into that product.

So those are real examples of the types of things that you can do in the over-the-counter market that you cannot do on an exchange-traded type market.

Senator CHAMBLISS. What if that were not available to you? What would be the effect of that unavailability?

Mr. DINES. It would be a far less precise hedge and a more costly hedge, and I know you would find market participants doing less hedging because of the costs.

Senator CHAMBLISS. We talked earlier about position limits and increased margins and what-not, and I think you used the phrase that this could create—would create a real drain on working capital.

From the standpoint of Cargill, do you have any idea of what kind of conceivable working capital drain you would be looking at for the volume that you do business in every day?

Mr. DINES. I think at times it could be significant. I guess maybe I would take you back to last March when we and other grain companies actually had to stop buying deferred grain from farmers, because of the run-up in grain prices and the demands on working capital to cover margins calls. Luckily, we were able to move some of our hedges to the OTC markets where we were able to put in place alternative credit arrangements and become reopened for business. And I think the important point here is that we would like to have the flexibility.

We do plenty of hedging on the exchanges. We do lots of hedging in the over-the-counter markets. The idea for us is that we like to have the flexibility, and that is very, very important for Cargill, but I do not have a number in mind, but I could tell you it would be significant.

Senator CHAMBLISS. Mr. Masters, you have conducted an analysis in which you extrapolated data from CFTC's commitment of trader report to determine speculative activity in the crude oil mar-

ket. Your analysis seems to assign values based upon index fund portfolios.

Now, do you assume that speculative activity was primarily occurring only in the index funds as opposed to the single-name commodities?

Mr. MASTERS. Thank you, Senator. We are assuming that the index funds were a primary participant last year with regard to commodities. There were also speculators in single-name commodities as well. We looked at the index fund data that was provided from the CFTC.

Senator CHAMBLISS. Well, what data is used to support your assessment that oil prices should have been falling last year when most expectations and market analyses showed prices continually increasing throughout the year due to geopolitical uncertainties, record OPEC stocks, a devalued dollar, and the increase in demand during the summer last year?

Mr. MASTERS. That is a good question. The issue with regard to prices in the futures market has to do with the supply and demand of futures. In the grains and the oil markets, the futures price is the price that determines spot, unlike other derivatives, unlike many other markets. You know, Platts, who is the largest spot pricing service, says in part, "We price off futures markets." Many spot market participants we talked to said, "We almost entirely price off futures markets off some basis."

So I think that what we did was we looked at the money flows going in and the money flows going out, and our sense was based on the data that there was an enormous amount of money going into the crude oil markets over the time, and after Congress looked at this issue and I think started really complaining about it to a certain extent, I think it led a great deal of money to come out of those markets, none of which had much to do with actual supply and demand. They amplified the price on the way up, and they greatly amplified the price on the way down.

Senator CHAMBLISS. Mr. Bookstaber, we talked with Chairman Gensler about the responsibility for determining whether or not a product is standardized or customized, and we talked about the clearinghouse that is going to clear it being the determinant of that.

What is your thought about that, are they the proper ones to determine whether something is customized or standard?

Mr. BOOKSTABER. The notion of standardization is a fairly loose one. The key is whether you can construct sufficient tagging for the product so that many other products can be put into the same basket and traded in a similar way. You know, ultimately the decision for standardization will be if it is on an exchange, is it sufficiently different from other products that people gravitate toward it as an item to trade? I do not know who the authority would be to say, oh, this is standard versus this is customized. It is something that still has to be defined.

Senator CHAMBLISS. OK. Mr. Driscoll, in talking about the Zelener fix, as the Chairman says, we had a very significant discussion on this issue last year during the farm bill debate, and we addressed the concerns of the lookalike forex contracts, and I am not sure in your statement that you made earlier, where you said that

there has been an increase in the number of complaints since Congress closed the loophole, whether you are talking about since the farm bill was enacted last year or are you referring to some previous date where a loophole was closed?

Mr. DRISCOLL. I was referring to last year in the farm bill. We have seen a large increase since a year ago today.

Chairman HARKIN. You mentioned gold and silver as commodities where there is the potential for fraudulent transactions. Any other commodities that need to be considered in that same respect?

Mr. DRISCOLL. Precious metals are by far the largest product that is being used in these non-forex Zelener type of contracts, but we have also seen energy type of products as well. And our view is that essentially you have to close the loophole for all commodities that are traded in futures markets because if you close off the ones that are currently existing, then next year we will be coming back and saying the fraudsters have now gone to other markets, because the people that trade these sorts of contracts and run these sorts of schemes are ones that are looking for a regulatory vacuum, and they have made careers of doing this. So we believe the loophole has to be closed for all commodities.

Senator CHAMBLISS. Ms. Stout, do you feel that all OTC markets create a systemic risk?

Ms. STOUT. No, probably not. I think something—that is actually a question that is not even necessarily something we have to address. I think a proper system of regulation of derivatives trading would prevent systemic risk from arising in any particular market. And I personally tend to favor what I think of as automatic circuit breaker rules of this sort rather than regulation that takes the form of creating some omniscient entity, some omniscient Government overseer who is supposed to investigate things on an ad hoc basis and look for potential problems.

I think with the right set of circuit breakers, the sorts that have been mentioned today—listing requirements, margin requirements, position limits—we do not have to worry about looking out for the development of systemic risk in particular markets because the system would look out for us.

Senator CHAMBLISS. Do you agree that some risk in markets is a good thing?

Ms. STOUT. Pardon me while I put on my pointy headed corporate finance professor hat. No, risk is never good. However, sometimes risk is inevitable if you want to accomplish something useful, like curing cancer or building a company that builds airplanes. But, no, risk itself is never good. We would like to get rid of all of it, if we could, and the real trick, I think, is to eliminate all the unnecessary risks while not throwing the baby out with the bath water and eliminating risk in productive areas and with regard to productive endeavors that we want people to undertake.

Senator CHAMBLISS. Well, having been in business myself, I have never made any money without taking a risk, and I just think it is extremely difficult and would be extremely expensive if we tried to take the risk out of it.

Mr. Chairman, I think that may be—I think that is all I had.

Chairman HARKIN. Thank you very much.

Mr. Masters, in your summary, you said, "What I have outlined in my testimony are not brand-new solutions; one, exchange clearing with novation and margin and, two, speculative position limits have proven effective over many decades of experience. In many ways, what we need to do is turn back the clock on several of the deregulatory measures that were undertaken in the last 15 years. The unintended consequences of those deregulatory decisions have been devastating for America." I agree.

Now off of that, I want to challenge you, Mr. Dines, on what you just outlined on this average price option. You say it is not offered by the exchanges. Well, why is it not offered by the exchanges? We have a chicken-and-egg thing here. See, now, I have said we ought to put all these on exchanges, you see. Well, if you are allowed to have them on over-the-counter markets, that is where they are. But who is to say that this average price option could not be developed as a product on a regulated exchange? That way you have more transparency, you would have more people involved, you would have more liquidity because you would have more people in that game. But as long as we have it in the over-the-counter market, with some opaqueness, lack of transparency, of course, the exchange is not going to offer it.

I had Mr. Duffy here last fall when we discussed this very thing, and I asked him that pointed question. I said in terms of my legislation, to put them on a regulated exchange, I asked him very pointedly. I said could your exchange—could the regulated exchange, not just his but the regulated exchanges handle this, and his answer was yes.

So, again, I have always asked, I keep asking this question—I asked two questions. One, define a customized swap. I still have not had one real defined yet, what is customized that does not have some impact someplace in the economy. If you have a customized swap on an interest rate or something like that, it may be between two individuals, but it may have other effects on a lot of other investors in other places. The same way with your hedging on the corn market. It could have a lot of effects.

I would submit that if you have it on a regulated exchange with more transparency and people know about it, quite frankly, I think your business will do better. I, quite frankly, think it will, and I think that the sellers will also do better, too, because it will be open and aboveboard. And we can call for margin requirements. Now, you had this problem with capital requirements. But that can be set. We can temper that, I think, through regulation on not having onerous capital requirements, but having some capital requirements, putting some skin in that game.

So, again, I want to challenge you on why you cannot do this on a regulated exchange.

Mr. DINES. Well, you could put average price options on exchanges. That could very well happen. But the degree of customization goes beyond that, and it goes to protection periods, it goes to protection levels, it goes to maybe how the average is determined. And the issue is that you can have multiple, multiple different variations of an average price option.

I want to be very careful. It does not mean that they are more complex. It means that they are tailored to precisely meet that hedger's needs.

I think it is impossible for the clearinghouses and the exchanges to do this. I do not think they can handle multiple forms, and the OTC market does it. We do it every single day. Our customers will say I want it to expire this particular day, I want it with this protection level, I want the averaging period to start here and end here. And to put that on an exchange will require standardization.

You go into the exchanges today, you can pick from a certain set of end dates. You can pick from a certain level set of protection levels. But you do not have the degree of customization you cannot customize. They just are not set up to do it.

So that I think is the primary difference. It is the ability to really work with customers to customize the product.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. I think a good example of the distinction—the gray area between standardized and customized is the equities option market. The CBOE is, as exchange traded. In that market you cannot get an exercise price of, say, 51.3.

Chairman HARKIN. Say that again? You cannot—

Mr. BOOKSTABER. The exercise prices for the options are in increments, maybe 5- or 10-point increments.

Chairman HARKIN. OK.

Mr. BOOKSTABER. So somebody could argue, wait a minute, this is not fulfilling my objective because I do not want an exercise price of 50 and I do not want an exercise price of 55; I want 52.23.

Well, of course, if you go to customized, the standardization is going to limit things to some extent, but the challenge is to go to Cargill, to go to the clients of JPMorgan, and to say let us look at the whole layout of the customizations that you do. Can we find a reasonable set of standard securities that get close enough to what people want that in the majority of cases they are fairly satisfied? Maybe somebody wants a time to maturity of 11.1 months, and another wants it of 10.9 months; 11 months might do the job for them.

So it is true that you cannot get standardization to meet every of the infinite possible numbers of times to maturity and the infinite number of possible exercise prices. But once you get to fine enough differentiation, that may be sufficient to deal with the large majority of what people demand.

Chairman HARKIN. Mr. Lenczowski.

Mr. LENCZOWSKI. Thank you, Chairman. I would agree with Dr. Bookstaber that there could be a degree of standardization that is achievable. But even with that standardization, the company that is looking to hedge its risk will still have to post the margin to the clearinghouse. And you mentioned, Chairman, that we could maybe regulatorily affect that margin. It is actually incredibly important that that margin be what the clearinghouse says it is because the clearinghouse has to act as the ultimate credit support to everyone. So it sets its margin requirements based on what it feels through its risk models the risk of a particular transaction is.

So the clearinghouse sets that margin requirement, and then it requires the most liquid form of collateral, because as soon as a de-

fault occurs, the clearinghouse has to instantaneously apply that collateral against the defaulted position. There is no ability to wait and sell some property or land. It has to happen instantaneously. Again, that preserves the clearinghouse's stability.

So while, again, I agree that there could be standardization and it could actually suit certain customers' needs, many customers just do not have that liquidity, that cash right now, and that is why, among other reasons they use the OTC market.

I think there was a mention that the OTC market is not collateralized or that it has—that the customers pay for that margin somehow. In fact, many times when these customers go to the OTC market, the collateral that they pledge is the exact same collateral that they have pledged to secure their loan obligations. Many customers borrow on a secured basis. They pledge land or equipment, fixtures, receivables, even intellectual property. That is all good collateral. It is very good. That supports our lending agreement, our money we lend to them.

It serves both as credit support for the loan and also for the derivative, and that is the efficiency and the flexibility that OTC derivatives provide to corporate America. And that is why we think corporate America chooses the OTC markets instead of the exchange markets. It is not because there is anything wrong with the exchange markets. It is just that the OTC markets are more flexible and are able to address exactly the risks that the company wants to hedge.

Chairman HARKIN. Did you have any observation on this at all, Dr. Stout.

Ms. STOUT. No, not on this.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. If I can just indulge on this, I think this point—of course, it is better if you can post illiquid collateral. Of course, all of us would like to have that. But there is a problem if the instrument is highly liquid and can be liquidated very quickly, and what you have as collateral is very illiquid. This is what leads to liquidity crisis cycles. I have \$800 million that I have as collateral at a bank. I am in a market that for some exogenous reason drops by 10 percent. The bank says, "Come up with more capital, or we will start to liquidate." And suddenly they say, "Oh, but it is land. We cannot liquidate it in the same timeframe as this instrument."

So it is painful and, of course, we do not want to have it be the case, but I think if you have liquid securities, you have to have liquid collateral on the other side.

Mr. LENCZOWSKI. If I could, Chairman, just to respond.

Chairman HARKIN. Sure.

Mr. LENCZOWSKI. The size of our loan book at JPMorgan is roughly 10 times the size of our derivatives exposure, and much of that loan book is supported by this collateral that Dr. Bookstaber mentioned. It is relatively illiquid, but it is excellent quality collateral. We lend on that basis.

So what we allow our customers to do is to use that same collateral to support their derivative transactions. That is useful for them. It is not an unsafe and unsound banking practice. In fact,

our examiners who are onsite would be all over us if it was anywhere close to that.

So I would like to just clarify that this is very good collateral that we are receiving from our customer base and that it is a very big part of what makes these transactions happen for companies.

Chairman HARKIN. Let me ask that, Mr. Lenczowski. So you admit it is not liquid, and how much can that be leveraged? How much can you leverage something that is illiquid that is an asset or land or whatever, how much can you leverage that?

I think I can understand it if it is capital, but I do not know that I can understand it if it something else.

Mr. LENCZOWSKI. That is an excellent point, Chairman Harkin. Our credit officers make that exact determination. We have statistical models and other means of assessing what our probable exposure could be. We use many forms to do that, but we are able to decide from a credit standpoint how much we could do. Again, these determinations are reviewable by our regulators and we ensure that are done within safe banking practices.

Mr. DINES. Chairman Harkin, could I just add to that point for a second? We have probably 250 to 300 institutional type customers that we are providing products to. We margin with about 80 percent of those customers today. We are moving collateral back and forth with them. We are sending them daily position reports so they know what the value of their derivatives are. Again, they know the value. They are moving the collateral back and forth.

They are giving us liquid cash as collateral, or we are giving them liquid cash as collateral. The difference is that we do not think that a highly rated food or industrial company should be held to the same margining terms as a lower-quality, more leveraged company. And so we are flexible in our credit terms for them, so we may not make them post initial margin. We may give them a million-dollar threshold before they need to post margin. But we are still applying very strict credit standards. We are margining with them. But we are flexible in the way that we do that, and that is very, very important. A million dollars to a company today means a lot from an investment standpoint.

So that is the way that we are managing it. That is the benefit of the OTC market versus a standardized exchange, because if you think about the standardized exchange, it has to go for the lowest common denominator, because it is dealing with all sorts of companies all different levels of credit quality. So it has to build its risk, its margining on the worst possible credits that might be part of that clearinghouse or exchange, where in the OTC market you do not have to do that.

Chairman HARKIN. Ms. Stout.

Ms. STOUT. I think the last comment is very helpful for helping keep a perspective on what we are discussing here. You referred to a million-dollar savings today for Cargill. We are dealing with a crisis that I believe the figure that you mentioned this morning, Mr. Chairman, was \$4 trillion. I do not think anyone would dispute that for some businesses at some times, some forms of derivatives are definitely beneficial. I think the critical question has got to be how do we measure the benefits against the harms.

I am very sympathetic. I wish I could ensure that Cargill could always have the perfect hedge. But if maybe you have to inconvenience yourself a little bit and deal with a suboptimal hedge sometimes, and the social benefit we get is that we do not get another Lehman Brothers, another Bear Stearns, another AIG. Well, sometimes you have to put with a little bit of difficulty.

We are at a watershed moment, Mr. Chairman, I think, that is comparable to the situation we faced in the 1930's. Over the past decade, I think we can argue that the finance sector of our economy came close to cannibalizing the real economy. Derivatives were definitely part—not the only part, but one of the larger parts of that cannibalization process.

It is clear that we cannot sustainably go doing things the way we have done them for the last 10 years. You know, the definition of "insanity," doing the same thing and expecting different results. Every time in history in my research that we have attempted to deregulate derivatives, we have gotten the same results.

So on the theory that the perfect is the enemy of the good, any regulatory development that can begin to bring back the exposure that we have today, the exposure to systemic risk, to reduced economic productivity, to price bubbles, to fraud and manipulation, anything that can begin to ratchet that back would be a very good thing.

Chairman HARKIN. Anyone else? Yes, Mr. Masters.

Mr. MASTERS. I just want to make a couple points. With regard to the whole notion of multiple prices, volume-weight average prices, in the equities business we have probably in excess of 100 different ways on listed exchanges of trading those various kinds of orders. We can do algorithms that do all sorts of things that can literally wait every 2 minutes for an order and then only take the offer or sit on the bid all day, or hide or bob or weave or whatever. All those things are possible on listed exchanges. We do them every day in our own business.

Second, I would like to make this point because I think it is important. With regard to the notion of options at different strikes and so forth, we are one of the largest option traders in the United States, listed options, and one of the issues with regard to options is when you trade in over-the-counter option, there is someone on the other side that knows your position. That is a huge issue. I do not want them to know my position because if they know my position and it is just me and him, if something goes wrong I have got a problem, and he knows exactly what my problem is. And that goes on every day.

So there is a huge competitive advantage to a bank or a swaps dealer to have that position on with a customer because they are able to reverse engineer the customer's knowledge and flows. So having that liquidity, having an exchange being able to trade with perfect—being able to hide, if you will, I can trade on these options exchange, and people do not know who I am. And I can trade using various different orders. That is a great benefit, and it would be a great benefit to many other customers once they understand that little dynamic that goes around on Wall Street.

Chairman HARKIN. Pretty interesting.

Yes, Mr. Lenczowski? Then we will have to call this off.

Mr. LENCZOWSKI. Thank you, Mr. Chairman. Just a couple of points.

First, the exchanges have been trading equity options for quite a while now, and they are free for anyone who can open an account there. Certainly we have no desire in monopolizing the equity market in the over-the-counter business, and any customer who feels they will do better on an exchange should trade there and should feel free to trade there. What we do not want is to eliminate that choice from the customer. There are some customers who might choose facing an exchange-traded exact same product to trade in the over-the-counter market. And to that extent, that kind of a choice should be continued to be allowed.

Then, second, just to confirm, there is a straw man argument or some example that the banks are against regulatory reform or swap dealers are against regulatory reform. That is absolutely untrue. We support broadly the initiatives that the administration has announced and Chairman Gensler described today. I have outlined them in our written submission, and I would just like to reassert again that we do agree completely that something has to be done. We just want it done in the right way for the economy.

Chairman HARKIN. Any last words? I thought this was a very enlightening session. We could probably go on for some time. As a matter of fact, I have got Secretary Vilsack over in the Appropriations Committee that I have got to go over and listen to his testimony on his budget.

But as you know, we are wrestling with this, but I guess I end where I started. We cannot continue to do what we have been doing. We have got to make some changes, and there have got to be, I think, some fundamental changes in the way we do this.

Now, I have taken the position, you all know my bill, what I attempted to do in that legislation. However, I am always willing to look at other sides of that issue. But I guess from my own personal standpoint, I still come down to the more open we are, the more transparent we are, the more information that people have out there in a regulatory framework, the better off we are all going to be. And somehow we have got to, as Mr. Masters said, I think, get back to where we were before in some kind of a regulatory framework. And that is what we are going to have to wrestle with, exactly how we do that. No one wants to stifle innovation, as I said, but we have got to ask what that innovation is for.

Second, no one wants to get rid of speculation. We need speculators, but we do not want that bottle of aspirin every day. We just need maybe one. So we have to figure out how we provide that kind of liquidity in some kind of a regulated manner also.

So these are the things we are wrestling with. I think this panel added greatly to our thoughts on this and our pursuit of trying to figure out what we can do. I just would say to all of you that as we proceed on this, any other thoughts and suggestions you may have, please let us know, and we will be developing this legislation some time this year, probably not until this fall. We have the health care bill, and we have got a lot of other things we have to do, and we have to do the child nutrition reauthorization, too, this year. But this is something we have got to attend to, and I have talked to Mr. Peterson on the House side, and he wants to move

something this year, too. So I invite your constant input and consideration of what we are doing here.

Again, I thank you all very much for being here today. As I said, it was a great panel. I appreciate it very much, thank you; the Committee will stand adjourned.

[Whereupon, at 1:29 p.m., the Committee was adjourned.]

A P P E N D I X

JUNE 4, 2009

Statement of Senator Thad Cochran

Senate Committee on Agriculture, Nutrition and Forestry

June 4, 2009

Mr. Chairman, thank you for holding this hearing to review the current structure of futures market oversight and considering testimony about how best to improve transparency. It is critical that these markets remain a viable option for farmers and business operations choosing to hedge risks.

This is a subject that attracted our attention following last year's experience with such a volatile commodity market. This hearing will allow us the opportunity to hear from the Chairman of the Commodity Futures Trading Commission (CFTC) and other experts to learn more about options for increasing market transparency and oversight.

While I agree that more transparency is needed, we must avoid overreaching and eliminating the opportunity for participants to enter

contracts. Production agriculture utilizes these markets to maximize profitability, and I urge the CFTC to use their current authority to address concerns as Congress continues to consider additional legislative action.

I look forward to the testimony of our witnesses.

Testimony of Richard Bookstaber

**Submitted to the Senate of the United States,
Committee on Agriculture, Nutrition, and Forestry
For the Hearing: "Regulatory Reform and the Derivatives Markets"
June 4, 2009**

Mr. Chairman and members of the Committee, I thank you for the opportunity to testify today. My name is Richard Bookstaber. During my career I have worked extensively in risk management. In the 1990's I was in charge of market risk management at Morgan Stanley and then oversaw firm-wide risk at Salomon Brothers, continuing in that capacity for a short time after it was absorbed by Citigroup. Following that, I oversaw risk at two buy-side firms, Moore Capital Management and Ziff Brothers Investments, and ran an equity hedge fund at FrontPoint Partners. Most recently I worked at Bridgewater Associates, a large hedge fund headquartered in Westport, Connecticut. I left Bridgewater at the end of 2008.

Before working in risk management, I was one of the pioneers in the development of derivative products on Wall Street. Moving from academics to Morgan Stanley in 1984, I designed, priced and hedged derivatives, and had experience with derivatives in the equity, fixed income, commodity and foreign exchange markets. I wrote one of the first books on derivatives, *Option Pricing and Strategies in Investing*, (Addison-Wesley, 1981).

I am the author of *A Demon of Our Own Design – Markets, Hedge Funds, and the Perils of Financial Innovation*. Published in April, 2007, this book warned of the potential for financial crisis from the explosion of derivatives and other innovative products.

Although I have had extensive experience on both the buy-side and sell-side, I come before the Committee in an unaffiliated capacity, and represent no industry interests.

My testimony will focus on the need for reduced complexity and increased transparency in the derivatives markets. This can be accomplished by standardization of derivative instruments and ultimately by having derivatives trade on the exchange. Many of the issuers and users of derivatives have incentives for derivatives to remain complex and opaque, but these incentives are related to flawed objectives.

Complexity: The Problem with Derivatives

Derivative instruments – and I use the term broadly to include the swath of what are often termed ‘innovative products’ such as options, swaps and structured products – can improve the financial markets. They can allow investors to mold returns to better meet their investment objectives, to more precisely meet the contingencies of the market. They can break apart and package risks to facilitate risk sharing. In the parlance of academic finance, they allow investors to better span the space of the states of nature. These objectives were the focus in the nascent years of derivatives, in the decade or so after the development of the Black-Scholes-Merton option pricing methodology and the establishment of the Chicago Board Options Exchange.

As time progressed, however, derivatives found use for less lofty purposes. Derivatives have been used to solve various non-economic problems, basically helping institutions game the system in order to:

- Avoid taxes. For example, investors use total return swaps to take positions in UK stocks in order to avoid transactions taxes.
- Take exposures that are not permitted in a particular investment charter. For example, index amortizing swaps were used by insurance companies to take mortgage risk.
- Speculate. For example, the main use of credit default swaps is to allow traders to take short positions on corporate bonds and place bets on the failure of a company.
- Hide risk-taking activity. For example, derivatives provide a means for obtaining a leveraged position without explicit financing or capital outlay and for taking risk off-balance sheet, where it is not as readily observed and monitored. Derivatives

also can be used to structure complex risk-return tradeoffs that are difficult to dissect.

These non-economic objectives are best accomplished by designing derivatives that are complex and opaque, so that the gaming of the system is not readily apparent.¹

Viewed in an uncharitable light, derivatives and swaps can be thought of as vehicles for gambling; they are, after all, side bets on the market. But these side bets can pose risks that extend beyond losses to the person making the bet. There are a number of ways the swaps and derivatives end up affecting the market:

- Those who create these products need to hedge in the market, so their creation leads to a direct affect on the market underlying the derivative.
- Those who buy these instruments have other market exposures, so that if they are adversely affected by the swaps or derivatives, they might be forced to liquidate other positions, thereby transmitting a dislocation from one market into another.
- The market price of some derivatives can have real effects for a company. For example, the credit default swaps are used as the basis for triggering debt covenants, so if the swap spread for a company's debt rises above a critical level, it can have an adverse effect on the company. Indeed, a dislocation in the credit default swap market can have a more immediate and severe effect on a company than will a dislocation in its stock price, because the credit default swap spread has an impact on the ability of the company to obtain financing.²

¹ For example, the last point, hiding risk-taking activity, is facilitated by the opacity of the risk-return tradeoff for derivatives. Any derivatives trader worth his salt can construct a derivatives position that will seemingly print money, in all likelihood generate cash flow month after month, but will get that cash flow by taking on a subtle risk which will rarely be realized, but when realized will have a profound negative effect. Without proper modeling, this risk will not be manifest until it is too late. This means that derivatives are the weapon of choice for investors who are faced with a need to book immediate gains.

It also means derivatives are a quick sale to naive investors. There is no need to look back to P&G or Orange County for examples of this. I recently gave a talk to a group of central bankers from small countries, a number of whom had been pitted with derivatives called dual currency swaps, though these were really options that gave the countries a payout in the worse performing of two currencies. In exchange for taking this relative currency risk, the countries received an incremental return of a few basis points. I did not do the calculation, but my bet is that this incremental return left a substantial buffer for the banks that sold the swaps. And that the countries entered into the swaps without recognizing the level of risk they were taking on.

² For this reason, there needs to be strict oversight of credit default swaps to guard against manipulation. Such oversight is far easier for if they are traded on an exchange.

- Derivatives can change the behavior of the market. For example, when various bonds are packaged into Collateralized Debt Obligations, they become linked in a way that they might not be absent this packaging. As a result, the diversification potential within the market can be lower and the potential for contagion between market segments can increase.
- Those who are writing OTC derivatives are in effect providing insurance to the buyers, but without any regulatory requirements on minimum capital. Those writing these instruments may not be in a well-capitalized position to pay out in the event that the option goes into the money.

Regulation of Derivatives

Standardization and Exchange Trading

As I point out in *A Demon of Our Own Design*, complexity is one of the demons that makes our financial markets crisis prone. Complexity hides risks and creates unexpected linkages between markets. Derivatives are the primary source of this complexity, so to reduce the risk of crisis we must address the derivatives markets. We need a flight to simplicity.

The proposal for a centralized clearing corporation, while a welcome step, is not sufficient to do this. It may reduce counterparty concerns, but it will not provide the necessary level of standardization, transparency, price discovery and liquidity. To do that, we need to have standardized derivative products, and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in the transparency and efficiency, and will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivative-induced complexity have created.

Nonstandard OTC Derivatives and Innovation

One stated objection to standardization and exchange trading is that if a door remains open for complex OTC derivatives, then having the standardized products out in the light

of day will only accentuate the demand for the more shadowy and opaque products. An opposing objection is that the push toward standardization will squelch innovation in the financial markets. These concerns lead to demands by some to abolish all OTC derivatives, and by others to shrink from exchange trading. There is no need to move toward either of these two extremes.

Abolishing OTC derivatives is not a wise direction for regulation. There will be legitimate reasons for customized derivatives, and no doubt innovations will emerge with broad value to the financial markets. The point is not to stifle innovation, but to assure it is directed toward an economic rather than gaming end. Nor need exchange trading move activity into the shadows. Properly executed, we can have a combination of standardized exchange-traded instruments along with the continued development of customized OTC instruments.

Standardized exchange-traded derivatives will create high hurdles for any nonstandard OTC product a bank wants to push into the market. The OTC product will have worse counterparty characteristics, be less liquid, have a higher spread, and have inferior price discovery. To overcome these disadvantages, the nonstandard OTC product will have to demonstrate substantial improvement in meeting the needs of the investor compared to the standardized product.

In addition, stricter control and disclosure can be placed on nonstandard OTC derivatives both through investor demand and by regulatory mandate. Investors may demand that derivatives taken on their behalf be of the standardized exchange-traded form, or may require that if a nonstandard alternative is employed, it first be approved by the firm's risk manager. The regulator may mandate the disclosure of such derivatives positions and require a demonstration of how these instruments are being used and why they are being used in place of the standard instruments.³ The disclosure might be public – investment

³ The argument here is not for case-by-case approval of nonstandard products, nor for a regulator to dictate which derivatives can be traded OTC. The regulator does not have to make a determination that any one derivative is being employed for bona fide hedging purposes, or that the use of an OTC derivative is in some sense legitimate. By having on-going disclosure and justification, the investors and the regulators can see emerging patterns of abuse. There will be a point where a firm's use of the nonstandard products will move beyond the norm and will start to draw questions.

firms could justifiably balk at such disclosure now, but that justification is lessened if the firms have the choice of employing exchange-traded derivatives to avoid the disclosure – or, alternatively, the disclosure can be restricted only to the regulator.⁴

Even with these hurdles, there will still be the opportunity for innovation and for the application of the more complex derivatives where their value is compelling. But I believe we will not find many instances where a complex OTC derivative is pushed forward, because for most legitimate purposes the standardized products will be found to be adequate.

Incentives for Creating Complex OTC Derivatives

The current proposal for moving derivatives onto an exchange reminds me of a similar effort I made shortly after I arrived at Morgan Stanley twenty-five years ago. I proposed a simplified structure that would have allowed the interest rate swaps that were traded at the time to be replaced by a handful of standardized instruments. I met with the head of the swap desk and others running the Fixed Income Division to propose that this structure be put forward to allow exchange trading of swaps. I thought the proposal, which would have made the markets more transparent, liquid and efficient, would be greeted warmly, even enthusiastically. Was I wrong. I had yet to appreciate the incentives the industry has to make derivatives as complex and ‘one-off’ as possible.

For the bank, the more complex and custom-made the instrument, the greater the chance the bank can price in a profit, for the simple reason that investors will not be able to readily determine its fair value. And if the bank creates a customized product, then it can also charge a higher spread when an investor comes back to trade out of the product. For

The disclosure could include standardized tagging of positions that will facilitate aggregation and analysis. In this regard, see “Mapping the Market Genome”, <http://rick.bookstaber.com/2009-02/markup-languages-and-mapping-market.html>.

⁴ Disclosure of exposures in a form that allows aggregation across firms is critical for systemic risk regulation. As it stands now, we do not have the ability to sort through the web of counterparty risk or the extent of leverage and crowding in markets. The required data is readily accessible by the regulator for exchange-traded positions, but more aggressive disclosure is required to obtain these data for OTC positions. On the need for disclosure for systemic risk management, see *Testimony of Richard Bookstaber, Submitted to the Senate of the United States, Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment, for the Hearing: “Risk Management and Its Implications for Systemic Risk”, June 19, 2008.*

the trader, the more complex the instrument, the more leeway he has in his operation, because it will be harder for the bank to measure his risk and price his book.⁵ And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic objectives they might have in mind.

These incentives explain why there is an ongoing arms race in innovative products and why the financial institutions might have to be pulled less than willingly into any initiative to standardize derivatives or to move derivatives from over-the-counter onto an exchange.

Conclusion: The Pace of New Regulation

We should move toward standardization and exchange trading of derivatives. We should do this because it is the reasonable direction to take, not as a reaction to the current crisis, and not predicated on whether derivatives did or did not behave in any particular way, or whether they were villains or innocent bystanders. The role played by the current crisis is to provide the impetus for action, for making improvements to the derivatives market independent of the final verdict that history passes down with respect to these recent, tumultuous years.

The arguments for standardization and exchange trading of derivatives are compelling. But there remains much we do not know. Therefore it is important to move slowly, one market at a time; learning by doing rather than pushing for quick, wholesale solutions. Because there are markets that are beyond the purview of the CFTC, indeed beyond our borders, the natural pace will be a gradual one.

⁵ This suggests compensation should be withheld until a derivatives position is closed out and the profit is realized.



Testimony

Before the Senate Agriculture Committee

On

Regulatory Reform and Derivatives Markets

June 4, 2009

**Mr. David Dines, President
Cargill Risk Management**



My name is David Dines, President of Cargill Risk Management. I am testifying on behalf of Cargill, Incorporated and have been in the hedging and risk management services industry for 15 years.

I want to thank you for the opportunity to testify today.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient, competitive, and well-functioning futures markets and over-the-counter (OTC) markets.

Cargill is an extensive end-user of derivatives products, and is also active in offering risk management products and services to commercial customers and producers in the agriculture and energy markets.

One of the major challenges for policymakers and regulators is that the term "over-the-counter market" covers a vast array of products across a number of markets.

This broad definition highlights why it is extremely difficult to seek a one size fits all regulatory or legislative solution that still allows all interested parties to manage their genuine economic risks.

- **One major concern with the recent proposal by the US Treasury Department is that it appears to seek a regulatory solution for all OTC products in response to systemic risk posed by one particular market: credit default swaps.**

It is important to note that while we have witnessed the greatest economic crisis in 80 years, and perhaps the most volatile commodity market Cargill has ever seen, OTC contracts in the agriculture, energy, and foreign exchange markets performed well, did not create systemic risks, and in fact helped many end-users manage and hedge their risks during this very difficult time.

For the purposes of our testimony today relative to the US Treasury proposal, we will focus our comments on two categories of OTC products where Cargill is an active market participant:

- Agriculture and energy products
- Foreign exchange products

The Treasury proposal seeks to achieve four broad objectives:

1. Prevent Activities Within the OTC Markets from Posing Risk to the Financial System
2. Promoting Efficiency and Transparency Within the OTC Markets
3. Preventing Market Manipulation, Fraud, and Other Market Abuses
4. Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

We support these stated objectives and believe that steps can be taken to meet these goals, without denying end-users' access to an effective and competitive market. While we have not seen the specific details of the Treasury Department's proposal, we offer these observations based on the information available under each of the specific objectives.

Objective 1: Prevent Activities Within the OTC Markets from Posing Risk to the Financial System



The Treasury Department's outline seeks to apply mandatory clearing of all standardized contracts, impose robust margin requirements, including initial margin requirements for both standardized and customized contracts.

- The imposition of mandatory clearing and mandatory margining of tailored hedges will have a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies who have taken conservative business approaches and choose to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital requirements.
- The potential magnitude of this drain on working capital should be carefully weighed by all policymakers. Cargill is a member of the National Association of Manufacturers (NAM) and has worked closely with a coalition of NAM members concerned about the ability of end-users to efficiently access the OTC market.

I would like to submit for the record a letter from the NAM on this issue, as well as a recent letter from Chesapeake Energy, an Oklahoma-based end user of OTC derivatives and the largest independent producer of US natural gas.

The Chesapeake Energy letter provides an excellent example of how restricting access to credit by imposing mandatory margining could severely drain capital that could otherwise be invested to grow a business. In the one example provided here, over \$6 billion would have been taken away from running and expanding a job-creating business, and instead be left idle in a margin account until the maturation of the OTC contract. While not posting cash, Chesapeake had pledged collateral valued at more than \$11 billion to secure their derivative counterparties.

Expand this example across all of the businesses that use OTC products and the amount of capital diverted from growing the US economy would be severe, unless companies reduced their hedging and risk management.

- There is a misconception that OTC products do not have credit provisions, and are never collateralized or margined. A significant number of OTC transactions are collateralized or margined with collateral being moved daily to adjust for the change in market value. With futures, margining terms are standardized across all participants, while in the OTC markets credit and collateral terms vary and are set according to the credit quality of the hedger.
- With regard to mandatory clearing of standardized products, defining which products are "standard" and which products are "customized" is a complex issue that must be thoroughly examined by the appropriate federal regulator to avoid disrupting market segments that continue to perform well.
- The loss of tailored hedging tools will greatly impact the ability of companies to comply with current accounting standards (Financial Accounting Standard 133). This accounting policy requires hedges to precisely match the underlying risk in order to reduce income volatility.



The Treasury Department outline also indicates that substantial capital requirements could be placed on all OTC dealers.

- While some level of capital requirements might be appropriate, there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers. The agriculture and energy hedging sectors both have active non-financial institution OTC dealers who offer healthy competition in the market. No non-financial institution dealers have required any taxpayer-based financial assistance from the Federal government. It would be inappropriate to eliminate these competitors from the OTC market through legislative or regulatory action.

Recommendation: Regulatory requirements should be based on risk to the financial system and not one-size-fits-all.

Additional monitoring and transparency in the OTC markets (agriculture, energy, foreign exchange, and interest rates) is warranted and Cargill supports these efforts, but restricting working capital through major increases in mandatory margining in these markets is counterproductive.

Improved monitoring and transparency accomplishes the goals for the objective, without the increased expense and capital demands of clearing.

Objective 2: Promoting Efficiency and Transparency Within the OTC Markets

The Treasury Department's outline seeks to impose more recordkeeping and force trades on to regulated exchanges.

Recommendation: More record keeping and better disclosure would be helpful, although the regulator should be directed to focus on areas with the greatest risks.

As previously mentioned, mandatory movement of activities from the OTC market to an exchange-traded market does not seem warranted in those markets that have not created systemic risks to the financial system.

Objective 3: Preventing Market Manipulation, Fraud, and Other Market Abuses

The Treasury Department's outline seeks clear authority to police fraud, market manipulation, and other market abuses and the authority to set position limits on OTC derivatives that affect a significant price discovery function with respect to futures markets.

Recommendation: We support the CFTC having clear authority to police fraud, manipulation and other abuses.

The Commodity Futures Trading Commission is already using its existing authority and is receiving public comment on an Advance Notice of Proposed Rulemaking to address the enforcement of position



limits, address concerns about excess speculation, and help maintain the integrity of price discovery in the futures markets.

Cargill filed public comments with the CFTC on this proposal. In our comments, we support:

- Position limits for non-commercials
- Much greater transparency and reporting for over-the-counter markets.

A graphical summary, including the highlights of the comments, is included at the end of today's testimony as Appendix A. The entire comments are on file with the CFTC, and we would be happy to distribute them to members of the Senate Agriculture Committee.

Objective 4: Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

Recommendation: Products should be marketed and continue to be available to those parties who meet the current regulatory parameters as eligible market participants.

Summary:

1. Derivatives play an important role in helping companies manage risks. Exchange-traded derivatives are essential in price discovery and help facilitate basic risk management, while over-the-counter derivatives are essential to hedgers because they can be customized to fit a company's specific risk management needs.
2. Additional legislative and regulatory actions in the OTC market should:
 - a. Be risk-based, and not treat all products identically
 - b. Improve transparency and reporting
 - c. Seek to add minimal costs and disruptions to those products that have not posed systemic risks to the financial system
3. Mandatory clearing and margining:
 - a. Would severely reduce hedging activity
 - b. Would greatly restrict working capital at a time when it is in very short supply
 - c. Is not warranted for OTC products that have not created systemic risk
4. The CFTC, through its existing rule-making, is proposing much-needed steps and should continue to work on:
 - a. Ensuring the enforcement of position limits in related exchange-traded markets, principally agriculture and energy products
 - b. Improving the transparency and reporting of OTC products

We appreciate the opportunity to testify today and look forward to working with the Members of the Senate Agriculture Committee and other policymakers as this issue develops.



Appendix A:

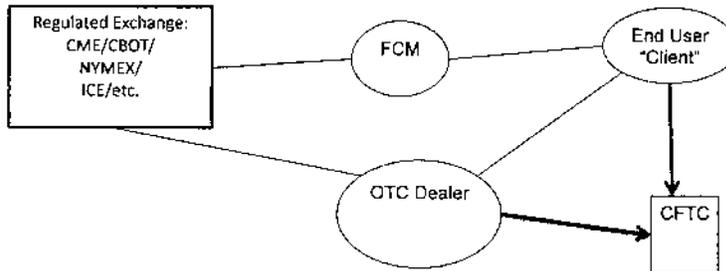
**CFTC Advance Notice of Proposed Rulemaking:
Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and
Create a New Limited Risk Management Exemption from Speculative Position Limits**

Highlights of Cargill's Suggested Changes as Outlined in Comments on CFTC Concept Release:

1. OTC dealer reporting to the CFTC once clients reach a significant size
 - Ensures compliance with exchange-related position limits
2. End user reporting to the CFTC once their activity reaches a significant size
 - Greater transparency
 - Ensures that if multiple dealers are used, the regulator knows the activity
 - Similar to Large Trader Position Reporting requirement
3. *Bona Fide* hedge definition limited to those physically involved with underlying commodity
4. OTC exemption that allows OTC dealers to facilitate customer transactions. A speculative position limit would apply if a dealer is trading on its own behalf, and not addressing client risk.

Graphical Summary of Recommended Changes:

Bold (Blue) Lines Indicate New Reporting/Compliance





**TESTIMONY OF DANIEL A. DRISCOLL
EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE
COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
UNITED STATES SENATE**

JUNE 4, 2009

My name is Daniel Driscoll, and I am Executive Vice President and Chief Operating Officer of National Futures Association. Thank you Chairman Harkin and members of the Committee for this opportunity to appear here today to present our views on closing a regulatory gap that allows fraudsters to sell unregulated OTC derivatives to retail customers.

Since 1982, NFA has been the industry-wide self-regulatory organization for the U.S. futures industry, and in 2002 it extended its regulatory programs to include retail over-the-counter forex contracts. NFA is first and foremost a customer protection organization, and we take our mission very seriously.

Congress is currently expending significant time and resources to deal with systemic risk and to create greater transparency in the OTC derivatives markets. Those are important economic issues, and we support Congress' efforts to address them. Understandably, most of the debate centers around instruments offered to and traded by large, sophisticated institutions. However, there is a burgeoning OTC derivatives market aimed at unsophisticated retail customers, who are being victimized in a completely unregulated environment.

For years, retail customers that invested in futures had all of the regulatory protections of the Commodity Exchange Act. Their trades were executed on transparent exchanges and cleared by centralized clearing organizations, their brokers had to meet the fitness standards set forth in the Act, and their brokers were regulated by the CFTC and NFA. Today, for too many customers, none of those protections apply. A number of bad court decisions have created loopholes a mile wide, and retail customers are on their own in unregulated, non-transparent OTC futures-type markets.

The main problem stems from a Seventh Circuit Court of Appeals decision in a forex fraud case brought by the CFTC. In the *Zelener* case, the District court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures, and the Seventh Circuit affirmed that decision. The "rolling spot" contracts in *Zelener* were marketed to retail customers for

purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In *Zelener*, though, the Seventh Circuit ignored these characteristics and based its decision on the terms of the written contract between the dealer and its customers. Because the written contract in *Zelener* did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures. As a result, the CFTC was unable to stop the fraud.

Zelener created the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals could sell retail customers forex contracts that looked like futures, acted like futures, and were sold like futures and could do so outside the CFTC's jurisdiction. For a short period of time, *Zelener* was just a single case addressing this issue. Since 2004, however, various Courts have continued to follow the Seventh Circuit's approach in *Zelener*, which caused the CFTC to lose enforcement cases relating to forex fraud.

A year ago, Congress closed the loophole for forex contracts. Unfortunately, the rationale of the *Zelener* decision is not limited to foreign currency products. Customers trading other commodities—such as gold and silver—are still stuck in an unregulated mine field. It's time to restore regulatory protections to all retail customers.

Back in 2007, NFA predicted that if Congress plugged the *Zelener* loophole for forex but left it open for other products, the fraudsters would simply move to *Zelener*-type contracts in other commodities. That's just what has happened. We cannot give you exact numbers, of course, because these firms are not registered. Nobody knows how widespread the fraud is, but we are aware of dozens of firms that offer *Zelener* contracts in metals or energy. Recently, we received a call from a man who had lost over \$600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints and mounting customer losses involving these products since Congress closed the loophole for forex.

NFA and the exchanges have previously proposed a fix that would close the *Zelener* loophole for these non-forex products. Our proposal codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*, which was the accepted and workable state of the law until *Zelener*. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts unless delivery is made within seven days or the retail customer has a commercial use for the commodity. This presumption is flexible and could be overcome by showing that delivery actually occurred or that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity.

This statutory presumption would not affect the interbank currency market dominated by institutional players, nor would it affect regulated instruments like securities and banking products. It would also not apply to those retail forex contracts

that are already covered (or exempt) under Section 2(c). It would, however, effectively prohibit leveraged non-forex OTC contracts with retail customers when those contracts are used for price speculation and do not result in delivery.

I should note that NFA's proposal does not invalidate the 1985 interpretive letter issued by the CFTC's Office of General Counsel, which Monex International and similar entities rely on when selling gold and silver to their customers. That letter responded to a factual situation where the dealer purchased the physical metals from an unaffiliated bank for the full purchase price and left the metals in the bank's vault. The dealer then turned around and sold the gold or silver to a customer, who financed the purchase by borrowing money from the bank. Within two to seven days the dealer received the full purchase price and the customer received title to the metals. In these circumstances the metals were actually delivered within seven days, so the transactions would not be futures contracts under NFA's proposal.

In conclusion, while NFA supports Congress' efforts to deal with systemic risk and create greater transparency in the OTC markets, Congress should not lose sight of the very real threat to retail customers participating in another segment of these markets. This Committee can play a leading role in protecting customers from the unregulated boiler rooms that are currently taking advantage of the *Zelener* loophole for metals and energy products. We look forward to further reviewing our proposal with Committee members and staff and working with you in this important endeavor.

**STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
June 4, 2009**

Good morning Chairman Harkin, Ranking Member Chambliss, and Members of the Committee. Thank you for your unanimous vote of confidence on my recent confirmation and for inviting me to testify. I am here today testifying on behalf of the Commission.

The topic of this hearing is of utmost importance during this crucial time for our economy. We must urgently enact broad reforms to regulate over-the-counter (OTC) derivatives. Such reforms must comprehensively regulate both derivative dealers and the markets in which derivatives trade. This is vitally important for the future of our economy and the welfare of the American people. I pledge to work closely with this Committee and the Congress on these reforms to build and restore confidence in our financial regulatory system.

In addition to working toward this much needed reform, I also will work to ensure that the Commodity Futures Trading Commission (CFTC) continues to fulfill its basic mission under the Commodity Exchange Act (CEA) to protect the integrity of the futures markets. I look forward to working with you to improve the capabilities and authorities of the CFTC to ensure that both our futures markets and the OTC derivatives markets are transparent and free from fraud, manipulation and other abuses.

Comprehensive Regulatory Framework

A comprehensive regulatory framework governing OTC derivative dealers and OTC derivative markets should apply to all dealers and all derivatives, no matter what type of derivative is traded or marketed. It should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, it should apply to the dealers and derivatives no matter what type of swaps or other derivatives may be invented in the future. This framework should apply regardless of whether the derivatives are standardized or customized.

A new regulatory framework for OTC derivatives markets should be designed to achieve four key objectives:

- Lower systemic risks;
- Promote the transparency and efficiency of markets;
- Promote market integrity by preventing fraud, manipulation, and other market abuses, and by setting position limits; and
- Protect the public from improper marketing practices.

To best achieve these objectives, we must implement two complementary regulatory regimes: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves – including regulated exchanges, electronic trading systems and clearing houses. Only with these two complementary regimes will we ensure that federal regulators have full authority to bring transparency to the OTC derivatives world and to prevent fraud, manipulation, other types of market abuses, as well as to impose position limits to prevent the

burdens of excessive speculation. These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved.

Regulating Derivatives Dealers

I believe that we must explicitly regulate the institutions that deal in derivatives. In addition, regulations should cover any other firms whose activities in these markets can create large exposures to counterparties.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. The AIG subsidiary that dealt in derivatives – AIG Financial Products – for example, was not subject to any effective regulation. The derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks were not subject to mandatory regulation either.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we can oversee and regulate the entire derivatives market. I believe that the Commodity Exchange Act should be amended to provide for the registration and regulation of all derivative dealers.

The full, mandatory regulation of all derivatives dealers would represent a dramatic change from the current system in which some dealers can operate with limited or no effective oversight. Specifically, all derivative dealers should be subject to capital requirements, initial margining requirements, business conduct rules and reporting and recordkeeping requirements. Standards that already apply to some dealers, such as banking entities, should be strengthened and made consistent, regardless of the legal entity where the trading takes place.

Capital and Margin Requirements. The Congress should explicitly require regulators to promulgate capital requirements for all derivatives dealers. Imposing prudent and conservative capital requirements, and initial margin requirements, on all transactions by these dealers will help prevent the types of systemic risks that AIG created. No longer would derivatives dealers or counterparties be able to amass large or highly leveraged risks outside the oversight and prudential safeguards of regulators.

Business Conduct and Transparency Requirements. Business conduct standards should include measures to both protect the integrity of the market and lower the risk (both counterparty and operating) from OTC derivatives transactions.

To promote market integrity, the business conduct standards should include prohibitions on fraud, manipulation and other abusive practices. These standards also should require adherence to position limits established by the CFTC on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

Business conduct standards should ensure the timely and accurate confirmation, processing, netting, documentation, and valuation of all transactions. These standards for "back office" functions will help reduce risks by ensuring derivative dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

Derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories complement central clearing by

providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions, and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the information recorded meets regulatory needs and that the repositories have strong business conduct practices.

The application of these business conduct standards and the transparency requirements will enable regulators to have timely and accurate knowledge of the risks and positions created by the dealers. It will provide authorities with the information and evidentiary record needed to take any appropriate action to address such risks and to protect and police market integrity. In this regard, the CFTC should have clear, unimpeded oversight and enforcement authority to prevent and punish fraud, manipulation and other market abuses.

Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public. No longer should the public be in the dark about the extensive positions and trading in these markets. This public information will improve the price discovery process and market efficiency.

Regulating Derivatives Markets

In addition to the significant benefits to be gained from broad regulation of derivatives dealers, I believe that additional safety and transparency must be afforded by regulating the derivative market functions as well. We should require that all derivatives that can be moved

into central clearing be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing and trading on exchanges or through regulated electronic trading systems will promote transparency and market integrity and lower systemic risks. To fully achieve these objectives, we must enact both of these complementary regimes. Regulating both the traders and the trades will ensure that we cover both the actors and the actions that may create significant risks.

Exchange-trading and central clearing are the two key and related components of well-functioning markets. Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearing houses for that market should continue as we extend regulations to cover the OTC derivatives market. In implementing these responsibilities it may be appropriate as well to consider possible additional information and other requirements of any systemic risk regulator that may be established by Congress.

Central Clearing. Central clearing should help reduce systemic risks in addition to the benefits derived from comprehensive regulation of derivatives dealers.

Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks. Currently, most of the contracts entered into in the OTC derivatives market are not cleared, and remain as bilateral contracts between individual buyers and sellers. In contrast, when a contract between a buyer and seller is submitted to a clearinghouse for clearing, the

contract is “novated” to the clearinghouse. This means that the clearinghouse is substituted as the counterparty to the contract and then stands between the buyer and the seller.

Clearinghouses then guarantee the performance of each trade that is submitted for clearing. Clearinghouses use a variety of risk management practices to assure the fulfillment of this guarantee function. Foremost, derivatives clearinghouses would lower risk through the daily discipline of marking to market the value of each transaction. They also require the daily posting of margin to cover the daily changes in the value of positions and collect initial margin as extra protection against potential market changes that are not covered by the daily mark-to-market. These practices are similar to the way clearinghouses for futures exchanges operate.

The regulations applicable to clearing should require that clearinghouses establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Working with Congress, we should consider possible amendments to the CEA to expand and deepen the core principles that registered derivatives clearing organizations must meet to achieve these goals to both strengthen these systems and to reduce the possibility of regulatory arbitrage. Clearinghouses should have transparent governance arrangements that incorporate a broad range of viewpoints from members and other market participants.

Central counterparties should also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm. Additionally, central clearinghouses should implement rules that allow indirect participation in central clearing. By novating contracts to a central clearinghouse

coupled with effective risk management practices, the failure of a single trader, like AIG, would no longer jeopardize all of the counterparties to its trades.

One of the lessons that emerged from this recent crisis was that institutions were not just “too big to fail,” but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled.

Exchange-trading. Beyond the significant transparency afforded the regulators and the public through the record keeping and reporting requirements of derivatives dealers, market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated transparent electronic trading systems. Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. A complete audit trail of all transactions on the exchanges or trade execution systems should be available to the regulators. Through a trade reporting system there should be timely public posting of the price, volume and key terms of completed transactions. This system might be similar to the Trade Reporting and Compliance Engine (TRACE) system currently required for timely reporting in the OTC corporate bond market.

The CFTC also should have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation and other abuses.

In contrast to long established on-exchange futures markets, there is a need to encourage the further development of exchanges and electronic trading systems for OTC derivatives. In order to promote this goal and achieve market efficiency through competition, there should be sufficient product standardization so OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another.

Position Limits. Position limits must be applied consistently across all markets, across all trading platforms, and exemptions to them must be limited and well defined. The CFTC should have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market.

Over the past few years, price spikes and unprecedented volatility in the commodity markets have hurt farmers, consumers and businesses. Record-high prices have not only inflicted costs upon American consumers and businesses, but record-high volatility has impaired the ability of many farmers and other businesses to use the futures markets to manage their price risks. As Chairman, I intend to ensure that the CFTC vigorously protects the integrity of the price discovery process in the futures markets and protects the public against fraud, manipulation and other abuses. I intend to ensure the agency does all it can to prevent excessive speculation from causing an undue burden on interstate commerce.

Standardized and Customized Derivatives

It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated. Regulations should also ensure that customized derivatives are not used solely as a means to avoid the clearing requirement. We will accomplish this in two ways. First, regulators should be given full authority to prevent fraud, manipulation and other abuses and to impose recordkeeping and transparency requirements with respect to the trading of all swaps, including customized swaps. Second, we must ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.

One way to ensure this would be to establish objective criteria for regulators to determine whether, in fact, a swap is standardized. For example, there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearinghouse, then it should be required to be cleared. Additional potential criteria for consideration in determining whether a contract should be considered to be a standardized swap contract could include:

- The volume of transactions in the contract;
- The similarity of the terms in the contract to terms in standardized contracts;
- Whether any differences in terms from a standardized contract are of economic significance; and
- The extent to which any of the terms in the contract, including price, are disseminated to third parties.

Criteria such as these could be helpful in ensuring that parties are not able to avoid the requirements applicable to standardized contracts by tweaking the terms of such contracts and then labeling them “customized.”

Regardless of whether an instrument is standardized or customized, or traded on an exchange or on a transparent electronic trade execution system, the CFTC should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation and other market abuses. No matter how the instrument is traded, the CFTC also should have clear, unimpeded authority to impose position limits, including aggregate limits, to prevent excessive speculation. A full audit trail should be available to the CFTC and other Federal regulators.

Authority

To achieve these goals, the Commodity Exchange Act should be amended to provide the CFTC with positive new authority to regulate OTC derivatives. The term "OTC derivative" should be defined, and the CFTC should be given clear authority over all such instruments. To the extent that specific types of OTC derivatives might best be regulated by other regulatory agencies, care must be taken to avoid unnecessary duplication and overlap.

As we enact new laws and regulations, we should be careful not to call into question the enforceability of existing OTC derivatives contracts. New legislation and regulations should not provide excuses for traders to avoid performance under pre-existing, valid agreements or to nullify pre-existing contractual obligations.

Achieving the Four Key Objectives

Overall, I believe the complimentary regimes of dealer and market regulation would best achieve the four objectives outlined earlier. As a summary, let me review how this would accomplish the measures applied to both the derivative dealers and the derivative markets.

Lower Systemic Risk. This dual regime would lower systemic risk through the following four measures:

- Setting capital requirements for derivative dealers;
- Creating initial margin requirements for derivative dealers (whether dealing in standardized or customized swaps);
- Requiring centralized clearing of standardized swaps; and
- Requiring business conduct standards for dealers.

Promote Market Transparency and Efficiency. This complementary regime would promote market transparency and efficiency by:

- Requiring that all OTC transactions, both standardized and customized, be reported to a regulated trade repository or central clearinghouses;
- Requiring clearinghouses and trade repositories to make aggregate data on open positions and trading volumes available to the public;
- Requiring clearinghouses and trade repositories to make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC and other regulators;
- Requiring centralized clearing of standardized swaps;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and

- Requiring the timely reporting of trades and prompt dissemination of prices and other trade information;

Promote Market Integrity. It would promote market integrity by:

- Providing CFTC with clear, unimpeded authority to impose reporting requirements and to prevent fraud, manipulation and other types of market abuses;
- Providing CFTC with authority to set position limits, including aggregate position limits;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring business conduct standards for dealers.

Protect Against Improper Marketing Practices. It would ensure protection of the public from improper marketing practices by:

- Business conduct standards applied to derivatives dealers regardless of the type of instrument involved; and
- Amending the limitations on participating in the OTC derivatives market in current law to tighten them or to impose additional disclosure requirements, or standards of care (e.g. suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

Beyond the need to bring broad reform to OTC derivatives dealers and markets, I would like to raise with the Committee two other important matters.

Retail fraud. In the 2008 Farm Bill the Congress clarified the CFTC's jurisdiction over fraud in retail foreign currency transactions. Since the passage of the Farm Bill, unscrupulous firms have been offering the same type of fraudulent "rolling spot" commodity contracts that were prohibited in the Farm Bill, but in other commodities that were not covered by the bill. Since the enactment of the Farm Bill, the CFTC has received more than 50 complaints from the public relating to potential fraud from such contracts. The regulatory reform package should include a provision to expand the CFTC's jurisdiction over this type of retail fraud to all types of commodities.

Foreign Boards of Trade. As part of regulatory reform legislation, the Congress should also provide the CFTC with clear statutory authority to ensure that traders that are trading on a foreign board of trade through trading terminals in the U.S. comply with the same U.S. position limits and reporting requirements when trading a foreign contract that settles against any price of a contract traded on a U.S. exchange. Foreign boards of trade should not be permitted to operate in the U.S. unless they impose and enforce comparable position limits on these contracts and provide comparable trading data to the CFTC as is regularly provided by the U.S. exchanges. This is often referred to as "closing the London loophole." Traders in the U.S. should not be able to avoid U.S. position limits or reporting requirements by moving their trades onto a foreign exchange.

Conclusion

The need for reform of our financial system today has many similarities to the situation facing the country in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress "the enactment of legislation providing for the regulation by the Federal Government of the

operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.” The Congress swiftly responded to the clear need for reform by enacting the Securities Exchange Act of 1934. Two years later it passed the Commodity Exchange Act of 1936.

It is clear that we need the same type of comprehensive regulatory reform today. Today’s regulatory reform package should cover all types of OTC derivatives dealers and markets. It should provide the CFTC and other federal agencies with full authority regarding OTC derivatives to lower risk; promote transparency, efficiency, and market integrity and to protect the American public.

Today’s complex financial markets are global and irreversibly interlinked. We must work with our partners in regulating markets around the world to promote consistent rigor in enforcing standards that we demand of our markets to prevent regulatory arbitrage.

These policies are consistent with what I laid out to this committee in February and the Administration’s objectives. I look forward to working with this Committee, and others in Congress, to accomplish these goals.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I look forward to answering any questions.

**Testimony of Mark Lenczowski
JPMorgan Chase & Co. (JPMC)
Senate Agriculture Committee
June 4, 2009**

Chairman Harkin, Ranking Member Chambliss, and Members of the Committee, my name is Mark Lenczowski, and I am a Managing Director and Assistant General Counsel at JPMorgan Chase & Co. I provide legal advice to our over-the-counter (OTC) derivatives businesses, primarily with respect to interest rate, foreign exchange and commodity transactions. Thank you for inviting me to testify at today's hearing.

Benefits of OTC Derivatives to Our Economy

For the past 30 years, American companies have used OTC derivatives to manage interest rate, currency, and commodity risk. Beginning in the early 1970s, global economic forces began to affect American companies, regardless of business type or scope of operations, and two key events are especially noteworthy:

- (1) the United States dropped the gold standard in 1971, which led to floating exchange rates;
- (2) severe oil price shocks led to increased volatility in commodity prices and interest rates.

These events presented complex financial risk management challenges that, left unmanaged, would have negatively affected many companies' financial performance and possibly even their viability. In response to marketplace demand, financial products, such as futures contracts and OTC derivatives, were developed to provide companies with tailored and flexible risk management tools.

Since their inception, OTC derivatives have been used by companies that are exposed to risks in the course of their day-to-day operations that they are unable to manage themselves. As a result, interest rate, currency and commodities derivatives became important and commonplace tools for these companies in 1980s and 1990s. Credit derivatives were developed over the past 10-12 years and -- when used responsibly -- have served a similar, useful role in managing credit risk. Since then, OTC derivatives have become a vital part of our economy. According to the most recent data, 92% of the largest American companies and over 50% of mid-sized companies use OTC products to hedge risk.

The role of entities like J.P. Morgan in the OTC derivatives market is to act as financial intermediaries. In much the same way financial institutions act as a go-between with investors seeking returns and borrowers seeking capital in the OTC derivatives market, we work with companies and other end-users looking to manage their risk with entities looking to take on those risks.

In this role, we work with many American and global companies and help them manage their risks. Recently, many of our clients have expressed great concern on the affects of the proposed legislative and regulatory changes on their businesses. Clients such as BP, Chesapeake, Constellation and Cargill are very worried about the unintended consequences of these policy proposals, particularly at a time when our economy remains fragile. In our view,

the effect of forcing such companies to face an exchange or a clearinghouse would limit their ability to manage the risks they incur in operating their business and have negative financial consequences for them via increased collateral and margin posting. These unintended repercussions have the potential to harm an economic recovery. We welcome the opportunity to discuss these issues today.

Let me first discuss in detail some of the benefits of OTC derivatives.

{1} Tailored Risk Management

Companies today demand customized solutions for risk management, and the OTC market provides them.

Interest rates

As an example, a typical OTC derivative transaction might involve a company that is borrowing in the loan market at a floating interest rate. This product is similar to a variable rate home mortgage. To protect themselves against the risk that interest rate will rise, the company will enter into an interest rate swap. These swaps generally enable the company to pay an amount tied to a fixed interest rate, and the financial institution will pay an amount tied to the floating rate of the loan. Similar to the homeowner in a variable rate mortgage, if rates rise steeply, they have some protection. Every aspect of the swap can be tailored to the company's needs to ensure that the company is able to match its risks exactly. It is that customization that makes OTC derivatives so useful to companies.

Currencies and commodities

OTC transactions are used in a similar manner by a wide variety of companies seeking to manage volatile commodity prices and foreign exchange fluctuations.

For example, a company may be importing raw materials into the United States to manufacture a product that is sold all around the world – such as aircraft. That American company will want to protect themselves and their shareholders from bearing undue risk if the price of the dollar fluctuates against the currencies it uses to buy raw materials. With no change to its business model, it could find itself in a situation where the price to produce the planes is higher than the profit it makes from selling those planes, simply due to exchange fluctuations outside its control. It could also find itself exposed to changing prices in commodity raw materials, such as steel or fuel. Any responsible company would act to prevent putting itself in this kind of jeopardy and its employees, clients and shareholders at great risk.

In this example, the aircraft company will purchase a currency derivative in the OTC foreign exchange market that allows it to lock in the exchange rate for each of the currencies that it is exposed to. The company would also likely purchase a commodity derivative that will lock in the price of the raw materials. These transactions allow the aircraft company to focus on its core competency -- building planes -- rather than fearing foreign exchange or commodity price risk.

It is important to note that although interest rate and currency derivatives currently are offered

on US exchanges, few corporations use these exchange-traded contracts for two main reasons:

- Exchange-traded products are, by necessity, highly standardized and not customized. As a result, companies are unable to match their unique risks to the products that are offered on exchanges; and
- Exchange/clearinghouse collateral requirements are onerous. Clearinghouses (including those that support exchanges) require that participants pledge only liquid collateral, such as cash or short-term government securities, to support their positions in the market without regard to the credit quality of the company. However, companies need their most liquid assets for their working capital and investment purposes. Requiring a company to post cash as collateral means taking that cash out of the company's core business, which hurts the company and its employees.

(2) Collateral

In addition to customization, the other main benefit of OTC derivatives is flexibility with respect to its ability to provide collateral to support its derivative transaction. In the interest rate swap example, the financial institution may ask the company to provide credit support to mitigate the credit risk that it faces in entering into this transaction. Most often, that credit support comes in the same form as the collateral provided for the loan agreement. Thus, if the loan agreement is secured by property, fixtures and/or receivables, that same collateral would also be used to secure the interest rate swap. As a result, the company does not have to incur additional costs in obtaining and administering credit support for the interest rate swap.

The flexibility of the credit support arrangement provided by OTC products is best highlighted by contrasting it to the posting requirements the company would have faced had it executed its interest rate swap transaction on an exchange. The CME Group and its predecessor institutions pioneered risk management products and currently trade a wide variety of interest rate futures and options contracts, including interest rate swap futures, and all companies are free to enter into these contracts. (In fact, JPMC is one of the biggest users of these exchange-traded risk management contracts). However, the exchange requires a high degree of standardization in the contracts it trades, and requires that transacting entities post cash or cash-equivalent collateral to support their trades. In addition, collateral calls may be made up to twice daily, to account for market fluctuations. This requirement of readily marketable collateral is necessary to ensure the clearinghouse is protected from risk; the clearinghouse or clearing member must instantaneously apply that collateral in the event of a participant default.

A clearinghouse is a very highly collateralized central counterparty that becomes the buyer to every seller and the seller to every buyer. In order for the clearinghouse to perform its credit risk mitigating role in the financial system, it is essential for the clearinghouse to be able to calculate accurately how much collateral it needs from a participant to secure the transactions on which it faces that participant. This can only be done for derivatives that are sufficiently standardized and liquid to enable the clearinghouse to obtain prices quickly so that it can calculate how much collateral is needed. This cannot be done with illiquid or non-standard transactions.

Thus, in the example above, if the company had executed its hedge on the exchange, it would have had to post cash or readily marketable collateral upfront and up to twice daily thereafter.

By entering into the transaction in the OTC market, the company is able to use the same collateral that it already posted to secure its loan, with no additional liquidity demands or administrative burdens. This collateral is high quality, being the basis for the extension of credit in the loan agreement, but posting it does not affect the company's operations or liquidity. This flexibility to use various forms of credit support significantly benefits companies.

(3) Basis Risk

Another benefit to companies is that unlike exchange-traded derivatives, OTC derivatives match very closely the actual risks that companies need to manage. Without this fit, companies are exposed to so-called "basis risk" -- that is, the difference between the risk that is incurred and the benefit of the hedge. To the extent that there is misalignment of the risk and the hedge, companies will bear the risk of the difference, which could be significant, depending upon the volatility of prices and the level of standardization of the hedge. In fact, the precision of the "fit" determines whether companies qualify for hedge accounting, delineated in FAS 133, which has been developed to address the accounting for hedging transactions. Because of the tailored solutions available through the OTC market, using OTC derivatives is the easiest and most effective way for companies to achieve hedge accounting. Without hedge accounting, companies will see significant volatility in their financial reporting, obscuring the true value of their business.

While we believe that exchanges play an invaluable role, not all entities can or want to trade on exchange. Currently, end-users have the choice of entering into their hedging transactions on an exchange or in the OTC market. For most end-users, OTC derivatives are critical to their risk management, and risk management is critical to their operations in volatile times. We believe that end-users should continue to be allowed to have the choice to use these products.

Problems with use of OTC Derivatives

The discussion of the benefits of OTC derivatives is not to deny that there have been problems with their use, and it is essential that policymakers examine the causes of the financial crisis to ensure it is never repeated. While JPMC does not believe that OTC derivatives were the cause of the financial crisis, it is clear that AIG's near-failure and the consequent investment by US taxpayers involved a subset of credit default swaps as well as poor risk management by its counterparties. In addition, the regulatory framework did not subject AIG to a thorough, comprehensive review--the kind of regulatory oversight to which a national or state bank's derivatives activities are currently subject.

Despite the failures at AIG, it is critical to point out that the markets in these products have continued to be available for end-users, and defaults have been processed as the market infrastructure envisioned.¹ Nonetheless, we believe there is an urgent need for reform to

¹ For example, Lehman Brothers had a portfolio of OTC interest rate derivatives transactions that had an aggregate notional value of \$9 trillion and that was cleared through LCH Clearnet, a clearinghouse that clears the majority of OTC interest rate swap transactions entered into between financial intermediaries. Upon Lehman's bankruptcy, the clearinghouse auctioned the portfolio, pursuant to its rules, and eliminated the market risk without having to tap its guaranty fund. In addition, Lehman's bankruptcy triggered settlement of credit default swaps that referenced Lehman. It is estimated that there was up to \$400 billion of such transactions outstanding, in gross notional terms, but at settlement, after netting all positions, the

address systemic risks that have been revealed by the financial crisis and that reform should encompass OTC derivatives.

Proposals

JPMC believes it is imperative that the root causes of the financial crisis be addressed and that regulatory reform address systemic risk while preserving the benefits of OTC derivatives for end-users. To that end, we propose the following:

- **Financial regulation should be considered on the basis of function not form.** That is, the appropriate regulatory framework should be determined on the basis of what an entity does rather than what legal entity form it takes.
- **A systemic risk regulator should oversee all systemically significant financial institutions and activities.** We believe it is necessary to establish a systemic risk regulator charged with the responsibility to oversee all systemically significant financial institutions and that this regulator should have the capability to impose capital requirements on these institutions, to oversee their transactions with each other and with their customers, and to impose conditions on those transactions, such as collateral requirements.
- **All standardized OTC derivatives transactions between systemically significant financial institutions or professional intermediaries should be cleared through a regulated clearinghouse.** The standardization requirement is necessary because, as discussed above, only transactions with a degree of standardization are capable of being risk-managed by the clearinghouse and thus be eligible for clearing.
- **Enhanced reporting requirements should apply to all OTC derivatives transactions.** For cleared transactions, the clearinghouse would have data on aggregate trading volumes and positions as well as specific counterparty information. Non-cleared transactions should be reported to a trade repository on a frequent basis, and the repository should publish aggregate market data. The systemic risk regulator as well as market regulators such as the CFTC or SEC should have access to the trade-specific data, and regulators should also have the ability to request more detailed information as required.

Industry Actions

In addition to these proposals for federal legislative action, we believe that financial intermediaries can and should act in concert with regulators to begin to provide a more effective framework for the clearing of OTC derivatives products. Clearing of clearing-eligible transactions provides additional stability to the American financial system. By way of example, in the interest rate swap market, we clear 70% of new transactions. A significant portion of credit default swaps (CDS) have become standardized over time, and we have worked since

total payments owed were between \$6 and \$8 billion dollars. The calculation and payment process occurred in an orderly manner with no reported problems.

2005 with other financial institutions and the Federal Reserve to establish a central counterparty (CCP) to clear standardized CDS. The ICE Trust clearinghouse launched on March 9th and has begun clearing CDS. We anticipate that a significant majority of dealer-to-dealer CDS trading volume will ultimately be cleared as products are migrated to the clearinghouse. In the commodity derivatives market, we clear a significant amount of our inter-dealer OTC derivatives as well.

CDS Clearing

As the ICE Trust clears more clearing eligible CDS contracts, we anticipate that in the near future the large majority of dealer to dealer clearing eligible CDS contracts will be cleared as a matter of routine. Clearing is a highly transparent process, and anyone with access to the internet can view data free of charge. The data relates to daily volume traded, as well as the price used by the clearinghouse for calculating how much collateral the clearinghouse will require from each dealer. The links to the websites showing that data:

<https://www.theice.com/marketdata/reportcenter/reports.htm?reportId=98>
<http://www.markit.com/information/products/cds/cds-page.html>

Interest Rates Clearing

Currently this market clears using the London-based LCH SwapClear service. For outstanding trades as at the close of 2008, SwapClear clears approximately \$160 trillion in notional, which equates to roughly 50% of inter-dealer swap trades globally.

Commodities Clearing

During the three month period ending in February 2009, OTC commodity derivatives dealers cleared on average approximately 40% of their OTC energy derivatives transactions and 35% of other commodity derivatives (excluding metals and agricultural products). We anticipate these percentages will increase over time.

FX Clearing

Clearing has not been an industry practice because FX/currency OTC contracts tend to have shorter maturities, which generally decreases counterparty risk, and counterparty risk is the primary driver for the development of clearinghouses. However, discussions on this have begun among dealers and regulators.

JPMC is committed to working with Congress, regulators and other industry participants to ensure that an appropriate regulatory framework for derivatives is implemented. I appreciate the opportunity to testify and look forward to your questions.

Testimony of

**Michael W. Masters
Managing Member / Portfolio Manager
Masters Capital Management, LLC**

before the

**Committee on Agriculture, Nutrition and Forestry
United States Senate**

June 4, 2009

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Good morning, Chairman Harkin, Ranking Member Chambliss and Members of this Committee. I welcome the opportunity to appear before you today and testify on the very important topic of derivatives regulation.

EXECUTIVE SUMMARY

The derivatives markets present Congress, financial regulators and the Obama Administration with two very critical and very distinct problems. The first problem involves **systemic risk**, the risk of the world's financial system crashing, as we nearly experienced in the last four months of 2008. The second problem involves **excessive speculation**, whereby price bubbles occur in consumable commodity derivatives markets, pumping up the prices that Americans pay to feed their families, fuel their cars and heat their homes. While excessive speculation is not new, it has given rise to the very serious issue of **passive "investment"** in derivatives on consumable commodities.

The **systemic risk** problem can be virtually eliminated by mandatory exchange clearing with novation and daily margin posting. Nearly all over-the-counter (OTC) derivatives can clear through a Designated Clearing Organization (DCO). My testimony will detail exactly what elements of clearing are required to eliminate the risk to the financial system as a whole.

The **excessive speculation** problem can be eliminated by imposing aggregate speculative position limits. These limits must cover all trading venues and apply at the control entity level. Fifteen years ago almost all derivatives trading for consumable commodities such as crude oil, copper and corn took place on fully regulated futures exchanges where each commodity had a single liquid contract with strict speculative position limits in place. Today, derivatives trading on consumable commodities takes place across multiple venues. In order to effectively impose aggregate speculative position limits, all of those venues must be regulated equally, which will require closing all of the loopholes that have been opened up over the last 15 years.

To address the problem of **passive "investment"** in derivatives on consumable commodities, policymakers must first understand the critical distinction between financial derivatives and derivatives on consumable commodities. Once that is understood, it will become clear that the solution to the passive investment problem is the severe restriction of such damaging buy-and-hold "investment" strategies.

CURRENT BACKDROP

Near Collapse of the World Financial System

The world financial system, with Wall Street at its core, teetered on the brink of collapse during the last four months of 2008. This near meltdown had a catastrophic effect on our nation's economy, causing the loss of trillions of dollars in retirement savings and millions of American jobs, and requiring trillions of dollars in taxpayer money to flow to Wall Street to avoid a complete collapse.

The sums of money that have flowed to Wall Street during this crisis are almost beyond comprehension. The United States has doled out more money to fix Wall Street than we spent to fight all the wars in our nation's history, including World War I, World War II and the War in Iraq.

Many, including President Obama, have referred to this as the greatest economic crisis since the Great Depression. Congress owes it to the American people to understand and eliminate the existing weaknesses in our financial system in order to ensure that Wall Street never inflicts this kind of pain upon Main Street again.

The 2008 Bubble in Food and Energy Prices

The rapid deterioration of credit markets, which pushed our financial system to the brink, was greatly exacerbated by the meteoric and unjustified rise in food and energy prices during 2008. I testified extensively last year on the role of speculation in driving up the prices of life's basic necessities and the damaging effects that this had on our nation's economy. Time does not permit me to share all those facts and figures this morning, but I would refer you to my previous testimonies and the three reports that I have co-authored on the subject.¹

At this time, however, I would like to share a few key observations related specifically to the price of oil. According to the National Bureau of Economic

¹ May 20, 2008 – Testimony before Senate Homeland Security Committee
 June 23, 2008 – Testimony before House Energy Subcommittee
 June 24, 2008 – Testimony before Senate Homeland Security Committee
 July 31, 2008 – Report entitled "The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices"
 September 10, 2008 – Report entitled "The Accidental Hunt Brothers – Act 2: Index Speculators Have Been a Major Cause of the Recent Drop in Oil Prices"
 September 16, 2008 - Testimony before Senate Energy Subcommittee
 February 4, 2009 – Report entitled "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens"
 February 4, 2009 – Testimony before House Agriculture Committee
 All three reports can be downloaded from www.accidentalthuntbrothers.com.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Research (NBER), the United States entered an economic recession in December of 2007.² So U.S. economic output was dropping during the first six months of 2008. During that time, the worldwide supply of oil was increasing and the worldwide demand for oil was decreasing.³ With the world's largest oil consumer in an economic recession and with supply rising and demand falling, the price of oil should have been falling. Instead, oil defied the economic recession and defied the laws of supply and demand and rose an astronomical \$50 per barrel from the mid-\$90s to a peak of \$147 per barrel in just six months.

Beginning in mid-July, the oil bubble popped and the price of oil tumbled over \$110 per barrel from the mid-\$140s to a low of \$33 per barrel in less than six months. Never before in history has the price of oil fallen so far or so fast. Tim Evans, who is an energy analyst with Citigroup, summed it up the best, saying, "This is a market that is basically returning to the price level of a year ago, which it arguably should never have left, . . . We pumped up a big bubble, expanded it to an impressive dimension, and now it is popped and we have bubble gum in our hair."⁴

As I have documented extensively in my reports and previous testimonies, I believe the major factor behind this bubble in oil prices was the flow of speculative money into and out of the oil futures market.

The Potential 2009 Bubble in Oil Prices

While the threat of Congressional action in the summer of 2008 might have been a major catalyst for popping last year's speculative bubble in oil, nothing was actually done by Congress to put an end to the problem of excessive speculation. As a result, there is nothing to prevent another bubble in oil prices in 2009. In fact, signs of another possible bubble are already beginning to appear.

According to the Energy Information Administration (EIA), the available supply of crude oil in the United States is at a 20-year high, while the demand for crude oil is at a 10-year low.⁵ The International Energy Agency (IEA) sees a similarly bleak supply and demand outlook for the world as a whole.⁶ And yet, despite this glut of unwanted oil, the price has risen an amazing 85% per barrel from the mid-\$30s to mid-\$60s. In fact, oil prices increased more in the month of May than in

² "Determination of the December 2007 Peak in Economic Activity," Business Cycle Dating Committee, National Bureau of Economic Research, November 11, 2008. <http://www.nber.org/cycles/dec2008.html>

³ "World Oil Balance 2004-2008," Energy Information Association - United States Department of Energy, April 13, 2009. <http://www.eia.doe.gov/emeu/ipsr/t21.xls>

⁴ "The Official Demise Of The Oil Bubble," David Gaffen, Wall Street Journal, October 10, 2008.

⁵ "Are Wall Street speculators driving up gasoline prices?" Kevin G. Hall, McClatchy Newspapers, May 20, 2009.

⁶ "Investor Hopes for Rising Oil Demand Aren't Borne Out by Reality," Ben Casselman, Wall Street Journal, June 1, 2009.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

any other month for the last 10 years. How is this possible, given our current economic woes and the tremendously negative supply and demand picture?

There has been a chorus of voices from market participants, economists and even OPEC, squarely pinning the blame on speculators for unjustifiably driving oil prices higher.⁷ Today, the price of oil is determined not primarily by the familiar laws of supply and demand, but largely by the trading desks of large Wall Street institutions.

If Congress allows this to continue, then once again oil prices threaten to throw our economy back into a double-dip recession, squashing all of the Obama Administration's attempts to revive our economy. Your constituents are flat on their backs financially and will not tolerate gasoline prices rising to \$3 or \$4 per gallon. High energy prices pose a threat to the things this Congress is trying to achieve - climate change, health care, et cetera - because all of those initiatives will be deemed too expensive.

Something must be done. Congress must act now before the U.S. economy is once again brought to its knees.

PROBLEM ONE: SYSTEMIC RISK

There were many factors that led to the rapid deterioration in credit markets and large losses on Wall Street during 2008. There was, however, one single factor that threatened to bring down the financial system as a whole. That was the interlocking web of over-the-counter (OTC) derivatives exposures amongst the biggest Wall Street swaps dealers. Many financial institutions might have gone bankrupt or suffered severe losses, but the system as a whole would not have been imperiled were it not for these completely unregulated dark markets.

OTC derivatives are bilateral contracts entered into between swaps dealers and their customers and between swaps dealers and each other. These contracts are agreements to pay one another certain amounts of money based on the direction of some price series that the contract references. OTC derivatives can encompass interest rates, credit spreads, equities, foreign exchange, commodities and even things as intangible as the weather.

Embedded in every OTC derivative is a credit exposure between the two counterparties based on the likelihood that each counterparty will be able to pay if their bets turn sour. This credit component is a major concern, because often little or no margin collateral is required to be posted to enter into these transactions. For this reason, the major money center banks with the best credit

⁷ "OPEC Calls for Curbing Oil Speculation, Blames Funds (Update2)," Maher Chmaytelli, Bloomberg, January 28, 2009.

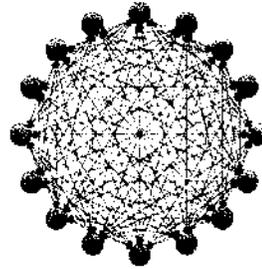
Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

ratings are also the largest swaps dealers, because they are the most sought-after counterparties.

The larger a swap dealer is, the more exposures they have to various counterparties and the larger the size of those individual exposures. Since there is a great deal of trading amongst swaps dealers, there is an interlocking web of very large exposures amongst the 20–30 largest swaps dealers.

At the peak in 2008 the notional amount of OTC derivatives contracts outstanding totaled over \$684 trillion.⁸ These positions represented an extreme amount of leverage, as very little margin collateral backed up these huge bets.

Graphical Illustration of
Interlocking Web of Exposures



When Lehman Brothers went bankrupt, many of the major swaps dealers, as well as Lehman Brothers' swaps customers, immediately lost large sums of money that they were owed. At that point, every swaps dealer radically reevaluated the creditworthiness of their counterparties and questioned who might be the next to fail.

While swaps dealers knew the extent of their own exposures, they did not know the extent of anyone else's exposure. They did not know if one of their counterparties lost so much money to Lehman Brothers that they, too, might be forced to file bankruptcy. Not knowing this information, their self-preservation instinct forced them to reduce all their counterparty exposures as much as possible, since they did not know who was viable and who was bankrupt. This phenomenon was multiplied as all of the swaps dealers' customers took the same actions to limit their exposures. The net effect was to force the OTC derivatives market to come to a grinding halt.

This unregulated shadow banking system, as it has been called, was effectively destroyed, which threatened to destroy the regulated financial system with it. At this point, regulators were forced to pump trillions of dollars into the shadow banking system to allow OTC derivatives dealers to make each other whole on their bets. This was necessary to prevent a domino effect of dealer collapses that would have destroyed the world's financial system.

⁸ Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008.
<http://www.bis.org/statistics/derstats.htm>.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The most notorious of these dealers has been AIG. AIG is not even a bank, but the Federal Reserve was forced to bail them out because if the Fed had allowed AIG to go under, they would have dragged the whole financial system with them.

SOLUTION: MANDATORY EXCHANGE CLEARING

The risk of a financial system collapse must be eliminated, not regulated.

The U.S. does not need a Systemic Risk Regulator. We need regulation that eliminates the risk to the system. A fundamental premise of finance is that return follows risk. Wall Street swaps dealers should not be allowed to earn an outsized return by putting our financial system at risk.

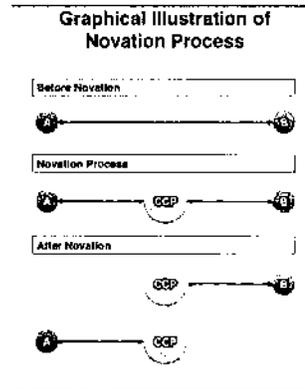
The problems inherent in the shadow financial system were two-fold:

- (1) The interlocking web of very large exposures between the major swaps dealers created the potential for a domino effect, wherein the failure of one dealer could lead to the failure of all dealers.
- (2) Losses did not have to be very high in order to force the first domino to fall, due to the extreme leverage that characterized those positions. This leverage was the result of requiring little or no margin collateral to be posted to insure those bets.

Everyone agrees that clearing needs to take place in order to increase the transparency of OTC derivatives markets. But not all clearing is created equal, and Congress must mandate that all OTC derivatives clear through a Designated Clearing Organization (DCO).

This clearing process must include two important provisions in order to counteract the two inherent problems in the shadow financial system. First, clearing must involve novation, wherein the DCO becomes the Central Counterparty (CCP) to both sides of the trade. And second, clearing must involve daily margin posting wherein the DCO/CCP collects daily margin variation payments from those dealers whose bets are going against them.

As an example, if Bank A enters into an interest rate swap with Bank B, then once that swap agreement clears, with novation, through the CCP, then the CCP becomes the counterparty to both

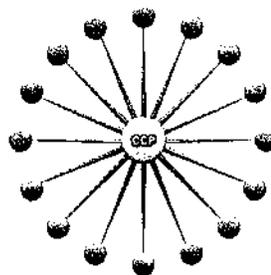


Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Bank A and Bank B. The result is that Bank A and Bank B are no longer counterparties to each other.

By insisting upon novation, the interlocking web of exposures amongst swaps dealers is eliminated, because every dealer's exposure is to the DCO/CCP. Another swaps dealer can go bankrupt and it will not affect any of the other dealers because they only have one counterparty – the Central Counterparty.

Graphical Illustration of Swaps Market with Central Counterparty (CCP)



To protect itself, the CCP will require that margin collateral be posted with the initial trade. The CCP will further require that additional margin collateral be posted on a daily basis as market prices fluctuate and those bets result in profits or losses.

As an example, on a \$100 million interest rate swap, each counterparty might have to post \$8 million (the actual amount will be determined by the riskiness of the swaps contract). Then, if at the end of any day, one counterparty is approaching an \$8 million loss on their position, the Central Counterparty will require them to post another \$8 million in order to continually ensure that they have the money to cover their bets.

If this system had been in place last year, then AIG would never have been forced to the brink of bankruptcy. AIG had been putting aside very little margin with which to pay its bets. When AIG's credit rating was downgraded and it was forced to post margin, it did not have the cash to do it. This liquidity squeeze could have been completely avoided if AIG's OTC derivatives trades had cleared with novation through a DCO that required them to post daily margin.

Wall Street Will Oppose These Steps

Recently, the New York Times and the Wall Street Journal have featured articles about what Wall Street is trying to do right now to block efforts at derivatives legislation which, if passed, will cut into their profitable swaps dealing business.⁹ There are three reasons why Wall Street does not like the idea of mandatory exchange clearing of all OTC derivatives.

First, though they express a desire for transparency and got burned last year by the lack of transparency, they know that with greater the transparency comes

⁹ "In Crisis, Banks Dig In for Fight Against Rules," Gretchen Morgenson and Don Van Natta, New York Times, May 31, 2009.

"Banks Seek Role in Bid to Overhaul Derivatives," Serena Ng, Wall Street Journal, May 29, 2009

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

narrower bid-ask spreads. As long as they can keep their clients in the dark as to what the true prices are for swaps, the longer they can charge their clients a substantial premium for entering and exiting trades.

Second, once all OTC derivatives are mandated to clear with novation (so that the DCO also becomes the CCP), their credit ratings will no longer be a competitive advantage. They will lose oligopoly pricing power because any two counterparties can trade, regardless of their respective credit ratings, since the CCP becomes the ultimate counterparty to all trades.

Third, they will lose access to unlimited leverage, and leverage ratios will have to come down from 30x or more to something closer to 12x. This means additional financing costs for each trade, which will cut into profitability.

Appropriate Standards for What Must Clear

Wall Street will seek to block mandatory exchange clearing by arguing that swaps are highly customized and that the vast majority of swaps cannot clear. While swaps might have certain elements of customization, they are, by their very nature, more standardized than Wall Street wants to admit.

Almost every OTC derivatives agreement references some published third party pricing service. As an example, for interest rate swaps it is often the London Interbank Offered Rate published by the British Bankers Association. This makes a swap based on LIBOR largely fungible with another swap that references LIBOR. After all, if these swaps were all unique then they could never be traded back and forth between swaps dealers.

For that reason, the standard that regulators should adopt for determining whether or not OTC derivatives should clear is not one of standardization versus customization but rather one of clearable versus non-clearable.

This standard was presented very clearly and forcefully by Chairman Gensler of the Commodities Futures Trading Commission (CFTC) during his confirmation hearing in front of this committee.¹⁰ He said repeatedly that if an OTC derivative can clear, then it should clear. This standard was reiterated by Treasury Secretary Geithner in his letter to Congress outlining the Administration's plans for derivatives regulation, where he said "if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared."¹¹

¹⁰ Senate Agriculture Hearing, February 25, 2009

¹¹ Letter to Senate Majority Leader Harry Reid from Treasury Secretary Timothy Geithner, May 13, 2009. www.financialstability.gov/docs/OTCletter.pdf

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Derivatives Clearing Organizations regulated by the CFTC have a more than 140-year history of serving as a Central Counterparty. They know which OTC derivatives are standardized and clearable compared with those that are customized and unclearable. As the CCP, they will not clear anything that they cannot value or assess the risk upon. DCOs can be trusted to not clear anything that is customized to the point that it should not clear. Congress will find that the vast majority of OTC derivatives can clear with novation through DCOs.

For the highly customized OTC derivatives that cannot clear, there is a very strong question as to their utility and their social value. Why would someone need to enter into a swap agreement that is so esoteric and inscrutable that a DCO is not willing to touch it? Given the extreme risk associated with such exotic (I would even say toxic) derivatives, banking regulators should require that those derivatives carry capital charges of 50% or more. Then, if a bank enters into a \$100 million exotic unclearable swap, they would be required to set aside \$50 million in capital to cover any potential losses arising from that bet.

Wall Street will try to shift the debate to standardized vs. customized in order to avoid clearing. Congress has the responsibility to make clearable vs. non-clearable the right standard.

CRITICAL DISTINCTION: FINANCIAL DERIVATIVES VERSUS DERIVATIVES ON CONSUMABLE COMMODITIES

Financial instruments are things like stocks and bonds that investors hold in order to receive dividends, interest, cash flows, etc. Because of these associated cash flows these instruments have intrinsic value as investments. Financial instruments are designed to be held (often for the long term) by investors in a portfolio. Stocks, bonds and other financial instruments are issued in the capital markets by corporations for the purposes of funding daily operations and making large project investments for future growth.

Commodities are things like crude oil, copper and corn that are produced from the earth or produced from things that are produced from the earth. The value that human beings derive from commodities comes from their ability to be consumed. Commodities are essential to our economy (like energy) or essential to life itself (like food). Modern society cannot survive without the ability to consume commodities.

Derivatives are financial contracts that derive their value from an underlying asset. Derivatives exist on financial instruments as well as on consumable commodities. The U.S. derivatives markets on consumable commodities date back to 1865; derivatives markets on financial instruments were established over

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

100 years later when the first foreign currency contracts began trading in the early 1970s.

Financial derivatives quickly came to dwarf derivatives on consumable commodities. In fact, in June of 2008 when there were \$684 trillion in outstanding OTC derivatives contracts, only \$12.6 trillion was on consumable commodities (less than 2%).¹² With this proliferation, market participants and regulators have lost sight of the critical differences between financial derivatives and derivatives on consumable commodities.

In the financial derivatives markets, every participant is a speculator. Therefore, there is no such thing as "excessive speculation" in financial derivatives. Investors can use financial derivatives to hedge price risk related to underlying financial instruments in their portfolios. An example would be an equity mutual fund manager who might sell S&P 500 futures to reduce his exposure to market risk. Investors can also use financial derivatives to take on price risk. That same equity mutual fund manager might buy S&P 500 futures when he receives an influx of investor cash to maintain market exposure while he is working into the individual stock positions.

In the derivatives market for consumable commodities, in contrast, there are two completely distinct classes of market participants: bona fide hedgers and speculators. Bona fide hedgers are the actual producers and consumers of the physical commodities. They come to the commodities derivatives markets with inherent price risk from their underlying businesses, which they seek to reduce or eliminate. This is achieved when a producer who needs to sell enters into a contract with a consumer who needs to buy. This way both the producer and consumer agree to a future price and thereby eliminate their price risk.

Unlike bona fide physical hedgers, speculators in the derivatives market for consumable commodities have no business in the underlying commodity and therefore no price risk to hedge. If they do not want to assume price risk then their choice is simple, they simply do not transact in these markets. Speculators can always avoid price risk by simply not transacting.

Bona fide physical hedgers do not have that luxury. They provide a vital service to the worldwide economy by producing the essential commodities that the world needs to consume to survive.

In 1936, recognizing that the derivatives market for consumable commodities was created solely for the benefit of bona fide physical hedgers, Congress enacted the Commodity Exchange Act. This legislation allowed for regulators to

¹² Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008. <http://www.bis.org/statistics/derstats.htm>. Please note these figures do not include gold or other precious metals.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

police the commodities futures markets for fraud, manipulation and excessive speculation.

Congress might have banned speculators from the commodities futures markets completely, but it was believed that a limited amount of speculation in the markets was necessary. Speculators were needed on the floor of the commodities futures exchanges so that when sell orders were transmitted via telegraph to the exchange floor, if they did not match up immediately with a comparable buy order (or vice versa) then the crowd of locals could fill those orders, buying and selling and balancing out the needs of producers and consumers. The locals in the pits acted essentially like middlemen or market-makers, similar to the way specialists operated on the New York Stock Exchange.

Perhaps I impute too much wisdom and forethought to Congress at the time but it seems like they were fully aware that buy orders and sell orders are what determine prices and that buying and selling - no matter who is doing it - will determine prices. For that reason, Congress put limits on speculators to ensure that bona fide physical hedgers were dominant in the price discovery process.

It was (and still is) essential that bona fide physical hedgers remain the dominant force in the commodities futures markets for four reasons:

1. **The commodities futures markets exist for the benefit of bona fide physical hedgers**, to provide a way to reduce risk and ensure the continued production of the essential commodities that our economy and citizens rely on every day for our existence.
2. **Bona fide physical hedgers trade to reduce risk, not to take on more risk.** Their primary business is producing and consuming, so their derivatives trading decisions are based on input and output, not emotion.
3. **Physical commodity producers and consumers trade based upon the actual physical supply and demand conditions that they are experiencing in their underlying businesses.** A farmer does not sell more wheat contracts than he actually intends to produce. A miller does not buy more wheat contracts than he actually intends to turn into flour.
4. **Speculative markets are susceptible to price bubbles.** Speculators throughout history have been famous for manias, panics and crashes. As an example, every significant capital market has had a major price bubble in the last ten years (emerging markets bubble, internet/tech bubble, housing bubble, etc). It is common for speculators, when they see prices rising, to pour money into a market, which causes the price to rise even more and attract even more speculators. This self-reinforcing cycle is what leads to price bubbles in excessively speculative markets.

PROBLEM TWO: EXCESSIVE SPECULATION

Excessive speculation is a condition of the derivatives markets for consumable commodities where speculators become more dominant in the marketplace than physical commodity producers and consumers. When excessive speculation is accompanied by speculative euphoria, completely unnatural bubbles occur in the prices for consumable commodities.

I label price bubbles in consumable commodities as unnatural because commodity prices naturally seek an equilibrium point equal to the marginal cost of production. As an example, if wheat prices fall below a level where the wheat farmer can cover his costs, then he will not plant any more wheat, which will result in reduced production and reduced supply, which will lead to higher prices in the future. If wheat prices rise to a level where the wheat farmer is making a dramatic profit above his costs, then he will plant as much wheat as he possibly can, which will increase production and increase supply and lead to lower prices in the future.

The decisions of physical commodity consumers also contribute to the stabilization of prices toward long-term equilibrium. When prices rise they demand less, which leads to excess supply and a falling price. When prices fall then they consume more, which leads to reduced supply and a rising price. So under normal conditions, commodities naturally stabilize around a long-term equilibrium level.

When speculators become dominant in the market for derivatives on consumable commodities, the supply- and demand-based trading of physical commodity producers and consumers takes a back seat to the high stakes trading of speculators as they attempt to out-trade each other to maximize their profits.

If speculators are dominant in a marketplace and a general sense of speculative euphoria takes hold, then a self-reinforcing cycle can set in where speculative inflows of money drive prices up and rising prices attract the inflow of more speculative money. This force can become powerful enough, given the tremendous amount of money that institutional investors have at their disposal, that commodity prices can become elevated well above long-term equilibrium prices over long periods of time.

When bubbles occur in the capital markets, those people left holding the securities at inflated prices suffer when the bubble pops. When bubbles occur in the derivatives market for consumable commodities, it is potentially devastating for every person on the planet.

Americans do not eat a bowl of stocks for breakfast. They don't fill their gas tanks with bonds. Bubbles in the capital markets typically do not hurt the

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

average American as they are expanding. But when speculators drive up food and energy prices, it inflicts tremendous pain on innocent bystanders.

SOLUTION: AGGREGATE SPECULATIVE POSITION LIMITS

Price bubbles have become possible in the commodities derivatives markets because of the proliferation of loopholes and the general dismantling of speculative position limits. In recent years, the United States government (at the behest of Wall Street) has effectively dismantled the system of speculative position limits that protected our commodities derivatives markets for more than 50 years. The result has been an unleashing of excessive speculation upon the American consumer.

In order to effectively put the genie back in the bottle, we must close all of the existing loopholes that were signed into law by the Commodities Futures Modernization Act of 2000 (CFMA) and apply aggregate speculative position limits across all trading venues. The rest of this section is dedicated to discussing exactly how to do that.

A speculative position limit is a limit on the size of positions that speculators can hold. Take, for example, Wheat on the Chicago Mercantile Exchange (CME). A speculator cannot control more than 6,500 contracts (either long or short). The purpose of these limits is to prevent speculators, individually and collectively, from exercising too much influence over prices.

Problem 2(A): The Swaps Loophole

Prior to the CFMA, the Commodities Exchange Act (CEA) forbade the idea of over-the-counter (OTC) derivatives on consumable commodities, and required that all derivatives trading occur on a regulated futures exchange. After the CFMA was signed into law in 2000, OTC derivatives on consumable commodities were allowed to proliferate, and they did, rising from a notional value of \$389 billion in December 2000 to a notional value of \$12,389 billion in June 2008 (a greater than 3000% increase).¹³

Because some bona fide physical hedgers have chosen to use the OTC swaps market to hedge their physical commodity exposures, the CFTC has granted a blanket exemption to swaps dealers, giving them virtually free reign to buy and

¹³ Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008. <http://www.bis.org/statistics/derstats.htm>. Please note these figures do not include gold and other precious metals.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

sell enormous quantities of futures contracts without being subject to position limits.¹⁴

This is the swaps loophole: since swaps dealers have free reign to buy and sell in unlimited quantities, a hedge fund looking to speculate in a commodity like wheat (which still has position limits) can enter into a swap of unlimited size with a swaps dealer who can then access the wheat futures market, buying or selling wheat futures far in excess of position limits.

The CFTC justified this practice by saying that the swaps dealer is hedging risk like a bona fide hedger. But they failed to make the critical distinction that wheat farmers incur price risk while producing a valuable commodity used to feed the world, while swaps dealers incur price risk as they try to enrich themselves by serving as a conduit for speculators to avoid position limits.

To their credit, the CFTC has announced their intention to re-examine the swaps loophole and to look for ways to put more restrictions on swaps dealers' access to the futures markets.

Solution 2(A): Mandatory Exchange Clearing for Derivatives on Consumable Commodities Makes Aggregate Speculative Position Limits Simple to Implement

The best way to close the swaps loophole is to mandate that all OTC derivatives on consumable commodities clear through an exchange with novation and daily margin. As outlined earlier, mandatory exchange clearing needs to happen for all OTC derivatives in order to eliminate systemic risk. It is especially important for OTC commodity derivatives, because that will enable regulators to effectively close the swaps loophole by looking through the swaps transaction to the ultimate counterparty.

When an OTC derivative such as a swap clears through an exchange, the exchange breaks that transaction into its component parts and becomes the central counterparty to both sides of the trade. When this happens, both the swaps dealer and their counterparty become counterparties to the exchange. This enables regulators to see both sides of the OTC derivatives transaction. Currently, regulators only see the futures trades that the swaps dealer makes in order to hedge their OTC derivatives transaction.

¹⁴ Please note that while some regulated commodities futures markets still have stated position limits, many do not. On NYMEX for instance, position limits have been replaced by position "accountability" limits, which are really not limits at all.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Example of How a Swap Would Clear

Swaps are generally composed of a futures-equivalent position and one or more basis positions. Commodity futures are designed to have broad-based appeal in order to attract the most liquidity. For that reason they typically choose the most popular grade(s) of the commodity, the most popular delivery point(s) and the most popular delivery time(s). Futures contracts also have a standard number of units (bushel, barrels, etc).

Swaps and other OTC derivatives allow for changes to one or more of these factors. Those differences between the futures contract and the swap contract are called basis. Heating oil and jet fuel, for instance, are both closely related middle distillates produced from crude oil. They trade closely to one another but not identically. You have to adjust for those basis differences when you go to hedge or clear a swap.

Let's use a simple example of a commercial airline that wants to hedge its consumption of jet fuel through a monthly swap that extends for 24 months (2 years). Keeping it simple, let's assume this swap is for 420,000 gallons of New York Jet fuel each month. A futures contract is for 42,000 gallons so this is the equivalent of 10 futures contracts.

Therefore once the swaps dealer enters into this swap with the commercial airline, he will buy 10 NY Heating Oil contracts in each of the next 24 months to hedge himself. This will cover most of his risk but not 100% of his risk. If the swaps dealer wants to be fully hedged then he can also enter into a NY Heating Oil for NY Jet Fuel basis swap. This basis swap is a product that trades through NYMEX.

Example of Swap Components

| | | | | |
|---------------------------|---|---------------------------------|---|--|
| New York Jet Fuel Swap | = | New York Heating Oil Futures | + | NY Heating Oil for NY Jet Fuel Basis Swap |
|---------------------------|---|---------------------------------|---|--|

If the airline and the swaps dealer take their swap to NYMEX for clearing then NYMEX will break the trade down into its two parts. The airline will be long 10 NY Heating Oil contracts in each of the next 24 months plus long a NY Jet Fuel for NY Heating Oil swap in those same months. The swaps dealer will be short 10 NY Heating Oil contracts in each of the next 24 months plus short a NY Jet Fuel for NY Heating Oil swap in those same months.

When the swaps dealer's cleared swap position (short 10 contracts x 24 months) is matched with the NY Heating Oil futures that he purchased in order to hedge

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

(long 10 contracts x 24 months) then the two will cancel each other out and he will have eliminated all his futures-equivalent risk.

The swaps dealer will only be left with the basis risk from the NY Jet Fuel for NY Heating Oil position. If he wants to totally eliminate his risk he can enter into a basis swap in the OTC markets or through NYMEX. Once he does this then those trades will also clear and at that point the swaps dealer will have no position.

In the meantime, the commercial airline has the exact position that it wanted to have, which is long 420,000 gallons of New York Jet Fuel each month for the next 24 months. Its position just happens to be NY Heating Oil futures plus a NY Jet Fuel for NY Heating Oil basis swap. And now the airline's counterparty is no longer the swaps dealer but NYMEX.

The Costs of Clearing for Bona Fide Physical Hedgers Is Outweighed By The Benefits

Experts agree that once virtually all over-the-counter derivatives begin clearing through an exchange, then bid-ask spreads will narrow substantially due to heightened transparency. This will substantially reduce the costs of entering and exiting positions, and the relatively modest cost of clearing will easily be offset by the change in spreads. When swaps dealers lose their oligopoly pricing power, their customers will win in terms of better pricing.

Bona fide physical hedgers will be required to post margin collateral with the Central Counterparty (CCP), but that collateral will earn interest. So physical hedgers will only be financing the spread between their borrowing rate and the interest they earn on collateral. Every swaps dealer includes a cost of capital and a credit charge in their swaps pricing. This is partially due to the fact that swaps dealers have to post margin when they access the futures markets to hedge. Physical hedgers have been paying this cost in the OTC markets all along; they just have not been explicitly aware of it.

Once spreads narrow, then liquidity in the OTC markets will most likely increase. This is what we observed in the stock market's switch to decimal prices. Bid-ask spreads quickly collapsed from a quarter (25 cents) or an eighth (12.5 cents) down to one or two pennies routinely. This led to more trading and therefore more liquidity.

In addition because of the existence of a CCP, anyone can trade with anyone else. The fact that everybody's counterparty is the CCP means that credit risk is no longer a consideration and counterparties are not limited to trading with large money center banks. Electronic trading will make it possible for producers to trade directly with consumers with no swaps dealer as a middleman.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Finally, the biggest benefit of mandatory exchange clearing for consumable commodities is that clearing enables the markets to be protected against excessive speculation. The best method for applying aggregate speculative position limits is to require OTC derivatives to clear first. Without substantially all OTC derivatives clearing it becomes very difficult for the CFTC to make those position limits apply. The costs of another speculative bubble are orders of magnitude greater than any costs brought on by exchange clearing.

This Solution Allows CFTC to Leverage the Computational Processing Power of the DCO

Mandating that all OTC derivatives transactions in consumable commodities clear through an exchange solves the problem of how to apply aggregate speculative position limits in the OTC markets. Once the transactions clear, they are broken into their nearest futures contracts equivalents plus a minor basis position. When all OTC derivatives transactions in consumable commodities can be seen by regulators, then it becomes simple to apply aggregate position limits to speculators' positions.

It also means that swaps dealers' swap positions net out with the futures hedges that they have executed against those swaps positions. This means that swaps dealers will only face position limits when they are unhedged, since an unhedged position is the same thing as a proprietary trading position. This is the exact effect that regulators should be looking for.

Under this system, the DCO does all the computational "heavy-lifting" for the CFTC in terms of breaking down OTC derivatives transactions into their component futures equivalents and then netting exposures to arrive at a net position. If OTC derivatives transactions are not forced to clear, then the CFTC must perform all these computational tasks themselves (instead of the DCO) to be in a position to effectively look through swaps transactions and place position limits on speculators in the OTC derivatives markets. The CFTC will, in essence, be forced to assume many of the roles of a DCO.

Problem 2(B): The London Loophole

Some Foreign Boards of Trade (FBOT) trade contracts that are virtually identical to the futures contracts being traded on U.S.-regulated futures exchanges. As an example the Intercontinental Exchange (ICE), which is an Atlanta, GA-based company, has a London-based subsidiary (the former International Petroleum Exchange), which is currently regulated by the U.K.'s Financial Services Authority (FSA). ICE trades a WTI contract that actually cash-settles based on the NYMEX WTI crude oil settlement price.

This is called the "London Loophole" because the ICE WTI contract is essentially fungible with the NYMEX WTI contract. The ICE WTI contracts have no

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

speculative position limits and they are currently not subject to CFTC regulation. But because the two contracts are virtually identical, they are tightly bound by arbitrage trading.

The CFTC allows this regulatory arbitrage to continue, even though it is certainly within their power to regulate a commodity contract with a U.S. commodity (West Texas crude) and a U.S. parent company. In fact, any FBOT that wants to have trading terminals in the United States must get the permission of the CFTC to do so and that permission can be conditional on meeting any requirements that the CFTC deems necessary. Likewise, the CFTC has to sign off on any contracts that are to be traded by U.S.-based traders.

Solution 2(B): Require Foreign Boards of Trade to Submit Comparable Data and to Take Comparable Remedial Action for Violations

The solution to the London Loophole is simple. Foreign Boards of Trade must be required to supply all the same data that Designated Contract Markets (DCMs) provide to the CFTC, and they must be prepared to enforce speculative position limits by forcing speculators to reduce over-limit positions.

Anyone trading in U.S.-regulated derivatives markets, whether that is on a DCM or OTC should be required to obtain a Large Trader Identification Number (LTIN).¹⁵ In addition, that trader should be required by law to provide their LTIN to any FBOTs that they trade upon. If speculators want to trade in our markets then they should agree to provide their LTIN to any FBOTs that they trade upon. Any traders that fail to provide their LTINs when trading abroad should be banned from trading in the United States.

As a condition for allowing FBOTs to place their terminals in the United States and to trade with American citizens and corporations, they must agree to share large trader reporting data (including LTIN numbers) with the CFTC on a daily basis. If the CFTC determines that a trader is over their speculative position limits, then the FBOT must agree to take appropriate actions to remedy the situation.

Right now the possibility for cross-border regulatory coordination is at an all-time high. G8 energy ministers just issued a statement this week along with OPEC calling for greater regulation to crack down on excessive speculation in the energy markets.¹⁶ The United Nations and Asian energy ministers have made similar calls as well.¹⁷ It could be possible to establish a global large trader

¹⁵ I discuss LTINs in depth later in this testimony.

¹⁶ "G8 ministers lay course on energy security, efficiency," Silvia Marchetti, Xinhua, May 25, 2009

¹⁷ "OPEC, Asia May Call for Curbs on Speculation in Oil (Update2)," Shigeru Sato and Yuji Okada, Bloomberg, April 26, 2009.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

reporting system given the current desire for greater global coordination and regulation. The CFTC should be authorized to share similar information on large traders with other foreign regulatory authorities that want to establish similar systems to monitor aggregate speculative position limits.

Problem 2(C): The Enron Loophole

The Commodities Futures Modernization Act of 2000 (CFMA) arbitrarily created a new category of commodities called "exempt commodities." CFMA allowed exempt commodities to be traded on Exempt Commercial Markets (ECM), free from speculative position limits and most all of the CFTC requirements of Designated Commercial Markets (DCM).

The flawed belief was that there were some consumable commodities (such as crude oil) that had such large deliverable supplies that they were not susceptible to manipulation. This is a grave error for two reasons.

First, a commodity that has a large supply but a similarly large demand is balanced so tightly that it does not take a great amount of effort to manipulate the market for that commodity. Second, as I have already detailed, derivatives markets for consumable commodities are not just subject to manipulation, but to excessive speculation as well. This flawed concept completely ignores the critical element of excessive speculation, whereby prices can be dramatically affected even if there is no specific intent to manipulate.

Solution 2(C): Require Exempt Commercial Markets to Become Designated Commercial Markets

Enron pushed hard for the inclusion of exempt commodities and ECMs in the CFMA, which is why this is called the Enron Loophole. They used this loophole to create Enron Online and then they reportedly used Enron Online to manipulate electricity markets on the West Coast of the United States.

With Enron bankrupt and discredited and the flawed concept of ECMs exposed, it makes sense to simply do away with the ECM designation. All ECMs should be required to convert to Designated Commercial Markets or shut down operations.

Gold and Silver Can Remain Exempt Commodities

Exempt commodities should be defined within the Commodity Exchange Act as gold and possibly silver. While gold and silver are commodities consumed in industrial applications, they historically have been recognized as stores of value, and have been used as currency for thousands of years. Therefore, they are considered by most to be more like investments than other consumable commodities.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Gold and silver have historically represented valid investment vehicles, and therefore do not need to be protected from excessive speculation by position limits.¹⁶ If a bubble were to occur in the price of gold, it would not have the devastating impact to someone's health or the health of the economy the way bubbles in food and energy prices do.

CFTC Must Set Aggregate Speculative Position Limits for All Derivatives on Consumable Commodities

Fifteen years ago, when there was only one trading venue for consumable commodities and, in most cases, only one futures contract for each basic commodity, it was very simple to apply speculative position limits. Today, because there are multiple trading venues and multiple variations on each basic commodity, it has become necessary to develop a system of aggregating those positions together in order to apply an overall speculative position limit.

The goal with aggregate speculative position limits is simply to treat speculators equally regardless of which trading venue they select to trade in. The playing field needs to be leveled so that speculators are not given the incentive to engage in regulatory arbitrage and move their trading from one (more transparent or more regulated) venue to another.

The CFTC must set the aggregate speculative position limits for all consumable commodities in order to protect those derivatives markets against excessive speculation. Exchanges can continue to set position limits for financial futures to protect against manipulation (where their interest is aligned with the public interest) but they should not be allowed to set aggregate speculative position limits for consumable commodities. There are two primary reasons for this:

1. The futures exchanges (like CME group), which have become for-profit public companies, have a duty to shareholders to maximize profits. There is an inherent conflict of interest between their shareholders' interest and the public interest as a whole. The public interest would dictate that speculative trading be limited as much as possible while still maintaining sufficient liquidity. Since the futures exchanges profit based on the level of volume, their shareholders would like to see no speculative position limits at all.
2. Because futures exchanges are no longer the sole venue for trading derivatives on consumable commodities, they are not able to form a comprehensive speculative position limit that covers their competitors in addition to themselves.

The CFTC needs to identify speculative position limits for the nearest to expiration contract period, all other contract periods, and an overall limit for all

¹⁶ Like financial futures, gold and silver still need to be protected from fraud and manipulation.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

positions combined. As an example, in crude oil, perhaps speculators should be limited to holding no more than 1,000,000 barrels in the prompt month, 3,000,000 barrels in any other single month, and no more than 5,000,000 barrels in total. Speculative position limits should be expressed in the underlying units (barrels and bushels), rather than the number of contracts, since OTC derivatives positions will be included for determining the aggregate limits.

A distinction is drawn for the nearest to expiration contract period because it needs additional protection to prevent manipulation as the derivatives enter the delivery period. A limit is imposed upon each individual contract period in order to prevent a speculator from concentrating all its trading in one period. And the overall limit is imposed to prevent a situation of excessive speculation in the commodity as a whole.

A speculator that violates position limits by holding larger positions than the limits would allow must be prevented from adding to these positions. This means that those positions become "liquidation only" and they can be reduced but not added to. A speculator that repeatedly violates position limits can face stiff monetary penalties and the CFTC can force them to liquidate their positions (on a pro rata share across trading venues) until they fall back below the limits.

Issue All Large Traders an Identification Number at the Control Entity Level

When large traders fill out CFTC Form 40, they should be issued a Large Trader Identification Number (LTIN). This LTIN must then be associated with every trade that clears, whether that trade originated on a DCM, DTEF, FBOT or OTC. At the end of every trading day, every clearing organization (including foreign clearing organizations) must report the positions of all large traders according to their LTIN. This accomplishes two things. First and foremost, the positions can be compiled by LTIN to see if any speculators are exceeding position limits. It also allows for the Commitments of Traders data to be collected daily instead of weekly.

Large Trader Identification Numbers (LTIN) must be issued at the control entity level. For instance one hedge fund gets one LTIN. Speculators cannot be allowed to create multiple shell subsidiaries in order to obtain multiple LTINs.

Bona fide physical hedgers who fill out Form 40 should also be issued LTINs. As part of Form 40, they should be required to indicate (under penalty of perjury) the size of their physical commodity business and whether they are selling commodities, buying commodities or both (middlemen). The LTIN can then be used to make sure that these physical hedgers are in fact hedging and not just speculating in the markets. For instance, an oil producer (who is long the price of oil to begin with) should not be allowed to establish a net long position in futures

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

contracts. Nor should they be allowed to establish a net short position that exceeds the size of their underlying business.

Positions Should Be Aggregated for the Basic Commodity

Any time there is a strong relationship between substantially similar commodities then those commodities should receive one aggregate position limit for the purpose of limiting excessive speculation. As an example, wheat is wheat, whether it's soft or hard, spring or winter, it's still wheat. Crude oil is crude oil, whether it's heavy or light, sweet or sour, it's still crude oil. If the price of light sweet crude skyrockets then that is going to have a substantial impact on the price of heavy sour crude. If the price of soft red winter wheat crashes, then that is going to have a substantial impact on the price of hard red spring wheat.

This is not to say that there are no differences between these commodities, but rather that the differences are extremely well-known and that is why there is a great deal of basis trading and arbitrage trading that takes place between substantially similar commodities. Any time there is arbitrage or basis trading there is a strong price discovery relationship. These basis and arbitrage trades are what "enforce" the relationship between these commodities and it is for this reason that they should be aggregated together under one speculative position limit.

As an extreme example, if a speculator wanted to buy 1 billion barrels worth of NYMEX WTI crude oil futures contracts, but was prevented from doing so by speculative position limits, and they purchased 1 billion barrels worth of ICE Brent crude oil futures contracts instead, then that would push up the price of ICE Brent. But it would also push up the price of all other crude oil contracts around the world, because a large fraction of the people selling those 1 billion barrels worth of ICE Brent would be arbitrageurs and basis traders who would be selling ICE Brent and simultaneously buying WTI, Dubai Sour, et cetera. Having speculative position limits on the NYMEX would go a long way to blunt the impact of this arbitrageur/basis trader buying (as long as those traders were not given exemptions from speculative position limits). But even with speculative limits, there are enough of these types of traders that it would be impossible for large magnitude price moves in ICE Brent not to have a significant effect on NYMEX WTI prices.

For this reason, the speculative position limits should be set for the commodity as a whole (crude oil) rather than for one particular grade or delivery location. One practical benefit of this approach is that exemptions for basis trading and arbitrage are not necessary because both legs of their trades fall under the same umbrella speculative position limit and therefore net each other out.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The 2008 Farm Bill introduced the concept of "significant price discovery" contracts. This gives the impression that it is somehow possible for two contracts on the same commodity to not have a significant impact on each other. However, this is not possible whenever arbitrage trading is occurring. The arbitrage and basis relationships between substantially similar commodities ensure that they always significantly affect one another from a price discovery standpoint.

Positions Should Be Aggregated Across Trading Venues

In our above example dealing with NYMEX WTI and ICE Brent, we talked about how two venues trading different grades of crude oil would still have a strong price discovery relationship binding them together. This relationship would be even stronger (virtually one for one) if we are talking about NYMEX WTI and ICE WTI where the deliverable grades are identical and one contract cash-settles against the other. Right now there are no hard and fast speculative position limits in either contract (except for the last 3 days on the NYMEX) so those two contracts are bound at the hip by arbitrage.

We gave another example earlier of an airline that approaches a swaps dealer about hedging their jet fuel exposure by entering a swap for 420,000 gallons of jet fuel per month for the next 24 months. To hedge this swap, the swaps dealer has two options: (1) they can go to the NYMEX and buy 10 heating oil contracts in the each of the next 24 months or (2) they can find a refiner that wants to hedge their jet fuel (or heating oil) production by entering into a swap to sell 420,000 gallons of jet fuel per month for the next 24 months.

In either case this swap has a direct price discovery impact on the futures market resulting in either 10 more heating oil contracts on the long side (if the swaps dealer hedges directly on the futures exchange) or 10 fewer heating oil contracts on the sell side (if the refiner hedges in the OTC markets rather than on the futures exchange).¹⁹ So it is clear from these two examples that the derivatives market for consumable commodities has multiple venues that are really just extensions of one another.

Because the trading venue does not matter in terms of the overall price effect on the market as a whole, speculative position limits need to be aggregated across trading venues. The objective is to simply level the playing field and treat all speculators equally regardless of whether they trade on a DCM, DTEF, FBOT or OTC.

¹⁹ Please note that if one swaps dealer trades with another swaps dealer, then the first dealer has simply passed along the problem of how to hedge to the second dealer.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Congress Should Define Excessive Speculation and Charge the CFTC with Enforcing an Overall Limit on the Amount of Speculation Present in the Derivatives Markets for Each Basic Commodity

The Commodity Exchange Act (CEA) does not clearly define the concept of excessive speculation. Perhaps Congress believed that the term was self-explanatory, simply meaning "too much speculation." But since the concept was not clearly defined, swaps dealers and the futures exchanges have been able to redefine it to mean something more akin to manipulation.

For that reason, I would propose that Congress amend the CEA to clearly state that excessive speculation is a condition of the derivatives markets for consumable commodities wherein speculators are a more dominant force in price discovery than bona fide physical hedgers. And when a state of excessive speculation exists, it is possible for speculative price bubbles to form.

Since a speculative price bubble in consumable commodities is potentially devastating to humanity, I believe Congress should mandate a percentage of open interest calculation to ensure that the positions held by speculators never exceed the positions held by bona fide physical hedgers (50% of the market). Then Congress should instruct the CFTC to adjust the individual speculative position limits so that the overall speculation percentage of the markets lies in the range of 15% - 35%.

Please note that the average consumable commodity futures market was about 25% speculative ten years ago.²⁰ It is only in the last ten years that we have seen a surge in speculation to the point where speculators now dramatically outnumber bona fide physical hedgers in many markets. With that surge in speculation has come a surge in the volatility of commodity prices – last year's bubble in crude oil prices being the primary example. We need sufficient liquidity in these markets, but we don't need excessive liquidity because that leads to excessive speculation and excessive price volatility.

With the proliferation of the Internet and electronic trading facilities, it is much easier for physical producers and consumers to transact amongst themselves without the need for speculators' liquidity. That is why 25% might be more than enough speculation to provide the markets with sufficient liquidity.

If there is too much speculation in the overall derivatives market for a consumable commodity (say 40%), then the individual speculative position limits must be adjusted downward to reduce the overall level of speculation. This can be accomplished through a series of "circuit breakers" which would be designed to keep overall speculation within a targeted range.

²⁰ These calculations can be found on pages 33-34 of our report "The Accidental Hunt Brothers" www.accidentalthuntbrothers.com

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

CFTC Should Semi-Annually Convene a Hearing of Physical Commodity Producers and Consumers to Recommend Aggregate Speculative Position Limits and an Overall Market Percentage for Speculation

To recognize the foundational fact that derivatives markets for consumable commodities exist solely to enable bona fide physical producers and consumers to hedge their price risk, Congress should mandate that the CFTC semi-annually convene a hearing of physical producers and consumers. These producers and consumers (for whom these markets exist) know whether or not the markets are working for them and whether or not they need more liquidity or less speculation. They are therefore in the best position to recommend aggregate speculative position limits for each commodity and also a target for an overall speculation percentage in that commodity derivatives market. The CFTC should adopt those recommendations or provide a detailed formal response to Congress as to why they are rejecting the proposals.

Congress Should Give the CFTC Explicit Power to Police OTC Commodities Derivatives Markets for Fraud and Manipulation

If OTC derivatives are allowed to trade off-exchange then the CFTC must be given explicit powers to police the consumable commodities OTC derivatives markets for fraud and manipulation. Commodities futures are fully regulated by the CFTC against fraud and manipulation. The physical energy markets are regulated by the Federal Energy Regulatory Commission (FERC) and Federal Trade Commission (FTC) for fraud and manipulation in natural gas/electricity and oil respectively. Therefore it makes sense that the OTC markets be regulated for fraud and manipulation as well. In the end, all regulatory arbitrage of this sort should be eliminated.

Passive "Investment" In Derivatives on Consumable Commodities is a New and Very Damaging Threat to the Markets

As mentioned earlier, the distinctions between financial derivatives and derivatives on consumable commodities have been blurred. Wall Street has pulled the wool over institutional investors' eyes and convinced them that derivatives on consumable commodities are a legitimate "asset class" and that it is possible to "invest" in commodities futures.

Derivatives have no value in and of themselves. All their value is derived from the underlying asset. In the case of consumable commodities, what is underlying these contracts are not securities or capital markets instruments, but the food and energy that Americans need to consume in order to survive and thrive.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

I hope that the U.S. government would not allow investors to buy up actual food or actual crude oil and hoard them because they are deluded into thinking they are making a good investment. We need those commodities to feed ourselves and fuel our economy. If investors, therefore, cannot "buy and hoard" the underlying commodities, then they should not be allowed to "buy and hold" the derivatives on those commodities.

Derivatives on consumable commodities do not pay interest, dividends or rents, and they have no associated cash flows because the underlying commodities have none of these things. In fact, in many cases consumable commodities have transportation and storage costs and decay over time, which means the "yield" from holding these commodities is negative.

Speculators are permitted in the derivatives markets for consumable commodities only because they provide liquidity. If someone attempts to "buy and hold" a position in commodity futures by continuously rolling it then that speculator is consuming liquidity. They have bought that contract perhaps from a bona fide physical producer and then rather than selling it to a bona fide physical consumer they hold onto it for "the long term."

Because these passive investors are almost always buying, their buying pressure pushes prices up. And since they are holding for the long term, it could be years and years before they sell. In the meantime, if enough people buy and hold, prices will increase and remain elevated for a long period of time.

Commodity index investment is an especially damaging form of passive investment that entails the buying and holding of a large basket (index) of consumable commodities derivatives. These investors do not trade on the basis of supply and demand. Instead, they blindly allocate money to crude oil, copper, corn, et cetera, which all have vastly different supply and demand dynamics.

Every barrel or bushel traded for reasons other than supply and demand is a barrel or bushel that distorts the price discovery function of the consumable commodities derivatives markets. Someone who buys one or more consumable commodities derivatives with the express intention of "hedging against inflation" damages the price discovery function of those markets by investing without regard for the underlying supply and demand conditions. In buying commodities futures, that misguided investor is actually causing inflation by pumping up commodity prices.

Passive "Investment" in Consumable Commodities Should Be Severely Restricted

For the reasons I just detailed, passive investment in these markets should be severely restricted. It is simple to define what constitutes passive investment. It

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

is a trading strategy that calls for maintaining a continuously long (or short) position in a consumable commodity.

Passive investors should face aggregate speculative position limits that are 10% or less than the limits faced by actively trading speculators. So, as an example, if the aggregate speculative position limit is 5,000,000 barrels for crude oil, then passive investors should only be allowed to buy and hold a maximum of 500,000 barrels of crude oil derivatives.

This also means that the levels for what constitutes a reportable position, for large trader reporting and identification purposes, should be reduced by a commensurate amount. So, as another example, if any speculator over 250,000 barrels typically needs to report their position then any passive investor over 25,000 barrels should be forced to report.

This regime of much tighter aggregate speculative position limits needs to apply to exchange traded funds (ETFs), exchange traded notes (ETNs), any other hybrid securities, as well as to commodity-based mutual funds. Any individual who wants to buy ETFs, ETNs or mutual funds that represent a passive investment in consumable commodities should be required to fill out Form 40 and obtain a Large Trader Identification Number (LTIN) before they can place their order.

The Commodities Futures Trading Commission (CFTC) Has the Experience and Skills to Implement these Recommendations and the Securities and Exchange Commission (SEC) and Federal Reserve (Fed) Do Not

In order to eliminate systemic risk and effectively implement a system of mandatory exchange clearing with novation and margin, we need regulators who are intimately familiar with the novation and margin processes. Futures exchanges have been novating contracts and assessing margin for over 140 years. The CFTC and its predecessors have been regulating these processes for over 70 years.

In contrast, the clearing processes for securities simply involve the transfer of money in exchange for the securities themselves. They do not involve novation or daily margin posting. Therefore, the SEC lacks the experience necessary to effectively regulate these areas. So does the Federal Reserve, who allowed the shadow financial system to proliferate under their watch and only intervened after the system began to crumble.

In addition, the CFTC and its predecessors have been imposing speculative position limits for over 70 years. They are the only regulator who has ever been charged with guarding the markets against excessive speculation.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The SEC presides over the capital markets where everyone is a speculator. They are unfamiliar with the concept of excessive speculation and have little experience with setting and enforcing position limits.

In fact in a gross example of regulatory arbitrage, the SEC has allowed passive commodity investments in ETFs, ETNs and commodity mutual funds. They have signed off on double-leveraged crude oil ETFs (like DXO) that allow any investor to make leveraged speculative investments in crude oil within their retirement accounts. This does not show good judgment from a consumer protection or a market protection standpoint.

The Federal Reserve has little experience in regulating commodities markets and setting speculative position limits. Most banks are forbidden to participate in the physical commodities markets, although the Federal Reserve has granted exemptions for the big commodities swaps dealers like Goldman Sachs, Morgan Stanley and J.P. Morgan. Since all banks would naturally be characterized as speculators in the commodities derivatives markets, the Federal Reserve seems like an illogical choice for guarding these markets against excessive speculation.

For these reasons, the CFTC is the best regulator to police the consumable commodities derivatives markets. They also are the best choice for overseeing the mandatory exchange clearing of the OTC derivatives markets as a whole because of their experience with novation and daily margin posting.

SUMMARY

In summary, let me say that the solutions I have outlined in my testimony are not brand new solutions. (1) Exchange clearing with novation and margin, and (2) speculative position limits have been proven effective over many decades of experience. In many ways, what we need to do is turn back the clock on several of the deregulatory measures that were undertaken in the last 15 years. The unintended consequences of those deregulatory decisions have been devastating for America.

I applaud you, Senator Harkin, for what you are trying to do with your recently introduced legislation. It appears that your legislation effectively slams the door shut on the loopholes that the Commodities Futures Modernization Act of 2000 opened up. There is no doubt that your legislation, because it requires mandatory exchange trading and therefore mandatory exchange clearing, would protect the financial system and eliminate the chance of another systemic meltdown. Likewise with all speculators trading on an exchange it would be simple for the CFTC to impose speculative position limits that treated them all the same.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

I believe the solutions that I have proposed in my testimony today would accomplish the same primary objectives as your legislation, while allowing the over-the-counter (OTC) derivatives markets to survive. I applaud you for your leadership on this issue and I look forward to working with you and your staff to ensure that America does not have to suffer through another financial meltdown or another speculative bubble in food and energy prices.

UNIVERSITY OF CALIFORNIA, LOS ANGELES



UCLA

BERKELEY • DAVIS • IRVINE • LOS ANGELES • MERCED • RIVERSIDE • SAN DIEGO • SAN FRANCISCO

SANTA BARBARA • SANTA CRUZ

LYNN A. STOUT
PAUL HASTINGS PROFESSOR OF CORPORATE AND SECURITIES LAWSCHOOL OF LAW
405 HILGARD AVENUE
BOX 951476
LOS ANGELES, CALIFORNIA 90095-1476
PHONE: (310) 206-8402
FAX: (310) 206-2122
E-MAIL: stout@law.ucla.edu

June 4, 2009

United States Senate
Committee on Agriculture, Forestry and Nutrition
Washington, DC 20510-6000

Dear Committee Members,

Thank you for inviting me to testify today. My name is Lynn Stout, and I am the Paul Hastings Professor of Corporate and Securities Law at the University of California at Los Angeles. My scholarly expertise includes the theory and history of derivatives regulation. I also serve as an independent director of a large mutual fund, giving me practical experience in the derivatives market. I have also published several academic articles on the topic of derivatives regulation.¹ Please allow me to note that my articles on derivatives, which I published in the 1990s, predicted that deregulating financial derivatives was likely to result in increased market risk, reduced investor returns, and price distortions and bubbles.² Those predictions, unfortunately, have proven correct.

Studying the history and theory of derivatives regulation inevitably leads to four basic conclusions. First, despite industry claims, derivative contracts are not new and are not particularly innovative. Although derivatives have gone by many different names, derivatives trading in the United States dates back at least to the early 1800s, and in other nations, centuries earlier. The 1884 Supreme Court case of *Irwin v. Williar*, for example, describes the contract law rules that applied to derivatives contracts in the 19th century. (They were then called "difference contracts.")³

Second, derivatives trading may provide some benefits to the overall economy. It is important to note, however, that while the industry routinely claims the social benefits from derivatives trading are substantial, there is no empirical evidence that supports this claim or establishes the magnitude of the supposed social benefits. At the same time, throughout history, unregulated derivatives markets have been associated with at least four distinct economic dangers. First, unregulated trading has been associated with asset price bubbles. Second, it has been associated with increased risk. Third, derivatives speculation has been criticized for reducing real economic productivity by diverting valuable resources, especially human time and creativity, away from industries and activities that contribute more to sustainable economic

¹ See e.g., Lynn A. Stout, *Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets*, 21 J. Corp. L. 53 (1995); Lynn A. Stout, *Insurance or Gambling? Derivatives Trading in a World of Risk and Uncertainty*, 1996 Brookings Rev. 39 (Winter); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L. J. 701 (1999).

² See, e.g., Stout, *Why the Law Hates Speculators*, 48 Duke L. J. 769-771 (arguing that making over-the-counter "OTC" financial derivatives exempt from the Commodities Exchange Act may erode average returns, increase market risk, and lead to price distortions and market bubbles).

³ 110 U.S. 499 (1884).

growth and to social welfare. Fourth, derivatives trading has been associated with increased levels of fraud and manipulation in underlying markets.

A third basic conclusion that can be drawn from studying the history of derivatives is that healthy economics regulate derivatives trading. My research indicates that the only time a significant US derivatives market has not been subject to regulation was during the eight years following the passage of the Commodity Futures Modernization Act of 2000 (CFMA). Although it was not widely appreciated at the time, the CFMA eliminated more than a century of legal restraints on derivatives trading by declaring that over-the-counter (OTC) financial derivatives were not subject to traditional contract law rules and were not subject to the Commodity Exchange Act (CEA) or the oversight of the Commodity Futures Trading Commission (CFTC).

Fourth, history teaches that successful derivatives regulation generally does not take the form of either a heavy-handed ban on all derivatives trading, or direct monitoring by some omniscient government overseer. Traditionally, derivatives markets have been successfully regulated through a web of procedural rules that include reporting requirements, listing requirements, margin requirements, position limits, insurable interest requirements, and limits on enforceability. These sorts of rules can be put in place ex ante, reducing the need for government to exercise discretion and giving derivatives traders certainty about what is and is not required of them. The rules also have the advantage of operating largely as automatic "circuit breakers" that make it unnecessary for regulators to have either initiative or omniscience. Finally, these traditional rules have a long track record of success (dating back decades and in some cases centuries) in permitting beneficial forms of derivatives trading while weeding out excessive risk, speculation, and manipulation. The most obvious recent example is the notable success that the CFTC has had since 1974 in preventing excessive speculation in the markets for commodities derivatives.

An Introduction to Derivatives

Let me begin by explaining that, although Wall Street often surrounds derivatives contracts with jargon that makes them seem complex and difficult to understand, derivatives are quite simple. A derivative contract is nothing more than a bet or gamble on what is going to happen in the future. Just as you might place a bet on the horse you expect to win a horserace (your betting ticket is your derivative contract), you can bet on future interest rates by entering an interest rate swap contract, or bet on a company's future creditworthiness by entering a credit default swap contract.

Until the 19th century, most derivative contracts were bets on the future prices of agricultural commodities, such as the rice derivatives traded in Japan in the 15th century and the commodities futures and options traded under the oversight of the CFTC today. To use the language of derivatives traders, the "underlying"—that is, the thing being bet upon—was the price of rice, wheat, or corn.

Financial derivatives, which became common in the U.S. in the 1800s, are simply derivative bets where the "underlying" is an interest rate, currency exchange rate, credit rating, or securities price, rather than wheat or corn. The first financial derivatives in the U.S. appear to have been stock options and futures, essentially derivative bets on the future prices of corporate stocks. The 1990s have seen an explosion in other forms of derivatives contracts, including derivative contracts on interest rates (interest

rate swaps), credit ratings (credit default swaps), and even weather derivatives. Contrary to industry claims, the development of large markets in financial derivatives was not the result of some new idea or "innovation." Rather, it was the result of the steady deregulation of financial derivatives trading.

Using Derivatives: Hedging or Speculation?

Derivatives trading can provide economic benefits. Most importantly, derivative bets can, at least in theory, be used as a form of insurance to hedge against risk. For example, if you own a corporate bond and you are worried the bond might decline in value, you can purchase a credit default swap that offsets your risk, because the swap will increase in value if the bond decreases in value. This is true hedging, and it serves a useful purpose by reducing risk.

But it is essential to recognize that derivative bets are also ideally suited for pure speculation. The economic literature defines speculation as the attempt to profit not by producing something or by providing investment funds to someone who is producing something, but by predicting the future better than others predict the future.⁴ Just as you can make money from predicting the outcome of a horse race without actually owning a horse, you can make money betting on the fate of a company by buying credit default swaps (CDS) without ever buying stocks or bonds that would actually provide investment funds to the company. In both cases, you are not contributing anything either to the welfare of the horse, or to the welfare of the company. And in both cases, you are increasing your risk level by making the bet, just as a gambler increases her risk level when she goes to the track.

Derivatives speculation may provide modest social benefits by increasing liquidity for the underlying and by marginally improving the accuracy of the market price for the underlying ("price discovery"). Again, however, while the industry routinely claims these benefits are substantial, no empirical evidence exists to support this claim. Without doubt, derivatives speculation can also provide very large financial benefits for individual traders (offset by some counterparty's loss), just as gambling can provide large benefits for individual gamblers (offset by some other gambler's loss). These speculative trading gains are purely private benefits, however, that come at other investors' expense. Meanwhile, unrestrained derivatives speculation has historically been linked to a host of very serious economic ills, including price bubbles and crashes, increased risk, reduced real economic growth, and increased fraud and manipulation.

This is probably why virtually every derivatives trader claims that he or she is using financial derivatives for hedging, not for speculation.⁵ This is also why hedge funds call themselves hedge funds, so as to create an impression they are not speculators trying to profit at the expense of average investors. In fact, it can be difficult to prove with certainty that any particular derivatives trade is not a hedge, because traders are usually clever enough to hypothesize some underlying risk they are supposedly exposed to that

⁴ See Lynn A. Stout, *Irrational Expectations*, 3 Legal Theory 227 (1997)(discussing theories of speculation).

⁵ In some cases, derivatives traders claim they are "hedging" when in fact they are using derivatives to offset some of the risk associated with taking a speculative position they would not have taken but for the availability of derivatives. This is the equivalent to a racetrack gambler claiming she is "hedging" when, in addition to betting on a horse to win, she also buys a ticket for win-place-show. In other cases, derivatives traders may have mistakenly thought they were hedging because they relied too much on the supposed accuracy of some "risk management" model.

the derivative supposedly offsets. Nevertheless, it is clear that by 2008, the market for CDS, for example, was primarily a speculative market.

We know this with mathematical certainty because by 2008, the notional value of the CDS market (that is, the dollar value of the bonds on which CDS bets had been written) had reached \$67 trillion.⁶ At the same time, the total market value of the underlying bonds issued by U.S. companies outstanding was only \$15 trillion.⁷ When the notional value of a derivatives market is more than four times larger than the size of the market for the underlying, it is a mathematical certainty that most derivatives trading is speculation, not hedging. And both economic theory and business history associate speculative markets with serious negative economic consequences.

Economic Problems Associated With Excessive Speculation

In particular, when a derivatives market becomes overwhelmed by speculation, we can expect to see several bad things happen. First, we can expect to see asset price bubbles and crashes. In effect, expectations in the speculative market, where derivatives gamblers can make very large bets using very small amounts of money, come to infect prices in the underlying market. An early example of this was the famous Dutch tulip bulb bubble of 1637, in which trading in newly-invented tulip bulb derivatives triggered a sudden increase and equally sudden crash in tulip bulb prices.⁸

Second, excessive speculation adds to systemic risk, because individual speculators lose or gain large amounts of money unexpectedly. The best recent example of this is the case of AIG, where speculation in CDS on the part of AIG traders who believed they could predict the future creditworthiness of corporate borrowers led to large and unexpected derivatives trading losses which threatened AIG's economic health, in turn threatening the health of AIG's trading partners. The result was a "domino effect" that threatened the stability of the banking system.

Third, excessive speculation reduces overall economic performance by draining valuable resources, including valuable human capital, away from more productive uses. Professor Simon Johnson of MIT's Sloan School of Management estimates that between 1973 and 1985, the financial sector of the US economy never earned more than 16 percent of U.S. domestic corporate profit. During the past decade, however, the finance sector took in as much as 41 percent of all corporate profit.⁹ Much of this profit reflects trading gains reaped by hedge funds and proprietary trading divisions of investment banks, which enjoyed these gains at the expense of average investors. Put differently, while derivatives speculation can be very profitable for individual speculators, from a social perspective it is a zero-sum game that consumes valuable social resources while making little or no contribution to social welfare or average investor returns.

⁶ Bank for International Settlements, *Quarterly Review Statistical Annex* at A103 Table 19 (Amounts Outstanding of Over-the-Counter (OTC) Derivatives) (December 2008).

⁷ *Id.* at A97, Table 16B (Domestic Debt Securities).

⁸ See Peter M. Garber, *Tulipmania*, 97 J. Pol. Econ. 535 (1989).

⁹ Simon Johnson, *The Quiet Coup*, *The Atlantic* (May 2009).

Fourth, the opportunity to trade freely in derivatives encourages fraud and price manipulation in the market for the underlying. To see why, assume a derivatives trader can easily buy \$100 million in CDS on a public company with \$20 million in outstanding stock. By spending just over \$10 million to buy a majority of the company's shares, then using its shareholder position to cause the company to pursue strategies that destroy value, the derivatives trader can reap an enormous profit on its \$100 million CDS trade which more than offsets the decline in the value of its \$10 million equity investment.

Regulating Derivatives: The Lessons of Experience

The economic dangers of derivatives first captured public attention in 1994, when Proctor & Gamble Co. announced an unexpected \$157 million dollar loss from speculative trading in interest rate swaps. Of course, Proctor & Gamble's loss was soon followed by much larger derivatives trading losses, including those that led to the collapse of Orange County's pension fund and of Barings Bank in the 1990s; to the near-collapse of Long Term Capital Management in 1998; to Enron's bankruptcy in 2001; and most recently, to the collapse of Bear Stearns and AIG in 2008.

Why did these losses occur? As we have seen, derivatives trading was not new. What was new, however, was that beginning in the early 1990s, trading in financial derivatives was increasingly made free from any sort of regulation. For example, in the 1990s, the CFTC granted a regulatory exemption from the Commodities Exchange Act for certain forms of financial derivatives, especially interest swaps. When the CFTC subsequently attempted to extend its jurisdiction to other types of financial derivatives, it was rebuffed by Congressional passage of the CMFA of 2000. The CMFA not only exempted most OTC financial derivatives from CFTC oversight, it also reversed, for the first time in American legal history, long-standing common law rules limiting their legal enforceability.

The unfortunate results of this deregulation are now obvious. How should lawmakers respond?

History teaches that there are a wide variety of well-developed, sophisticated, time-tested regulatory tools that can be brought to bear on the problem of regulating financial derivatives. These tools can protect the legitimate use of derivatives for hedging purposes, while discouraging excessive speculation. They do not require us either to ban all derivatives trading, or to attempt to subject derivatives markets to the oversight of a centralized, all-powerful regulator tasked with intervening on an ad hoc, discretionary basis. To the contrary, derivatives markets can be successfully regulated through a variety of regulatory requirements that do not prohibit derivatives trading but do subject trading to various reporting requirements, listing requirements, margin requirements, position limits, insurable interest requirements, and limits on enforceability. The obvious prototype for this regulatory approach is the successful regulation of commodities derivatives by the CFTC under the authority of the CEA. This approach has a number of advantages, including its emphasis on ex ante rules that provide certainty for traders; its reliance on automatic "circuit breakers" rather than agency discretion; and its time-tested success.

When it comes to regulating financial derivatives, there is no need to re-invent the regulatory wheel. The economic problems associated with financial derivatives are neither novel nor unique. They exist in any market prone to speculation. Similarly, the challenges associated with regulating speculation in financial derivatives, including the challenges of protecting legitimate hedging transactions and preventing speculative trading from migrating to other jurisdictions, are not unique. Logic and history suggest they

can be successfully addressed by the same sorts of regulatory rules we have employed, to great effect, in other markets prone to excessive speculation.

Lynn A. Stout
Paul Hastings Professor of Corporate Law and Securities Regulation
UCLA School of Law.

DOCUMENTS SUBMITTED FOR THE RECORD

JUNE 4, 2009

(137)

Exchanges Warn On OTC Clearing

Financial Times - June 3 2009 18:01

By Jeremy Grant in London

Three of the world's largest exchanges have warned regulators and lawmakers not to force too much of the over-the-counter derivatives markets into clearing houses, saying that market participants should have a role in deciding how far such products are shifted away from the opaque privately negotiated markets.

The comments on Wednesday, by executives at NYSE Liffe, Intercontinental Exchange and London Stock Exchange, come from businesses that are likely to be the main beneficiaries of a push by the Obama administration to ensure more OTC derivatives are cleared and traded on exchanges and other regulated trading platforms.

Tim Geithner, US Treasury secretary, has called for more OTC derivatives to be processed through clearing houses to reduce the counterparty risks associated with defaults, and for "standardised" OTC contracts to be traded on-exchange.

But exchanges, many of which own their own clearers, are concerned that legislation written by the US Congress should not go so far as to force the more complex, tailored OTC derivatives into clearing houses that are ill-equipped to deal with the risks associated with them.

In particular, they are concerned about how the unwinding of positions would be handled with such products, many of which are illiquid compared with standardised products.

Mark Ibbotson, chief operating officer at NYSE Liffe, the futures arm of NYSE Euronext, said: "The plea we'd have is mandates are kept to a minimum. Is it right that every [OTC derivatives] product should be put in a straitjacket on an exchange?"

"It could damage the security of a clearing house to force products on to a clearing house that shouldn't be there. We don't want mandated solutions, let's have us working with the market," Mr Ibbotson said at the Mondo Visione Exchanges Forum.

David Peniket, chief operations officer of ICE Europe, part of the US-based Intercontinental Exchange, said it was important to involve market participants in how far clearing is extended to the OTC markets.

He cited the gradual adoption by market participants of clearing in OTC energy markets after Enron's collapse.

ICE started offering clearing of OTC energy products in the early 2000s. The New York Mercantile Exchange, now owned by CME, launched Clearport, a similar service, in 2002.

"Regulators will certainly have markets that they want to encourage into clearing but I think it's very important to let markets develop their solutions," he told the Financial Times. "There is certainly a concern around mandatory solutions, that you damage liquidity."

Adam Kinsley, head of regulation at LSE, said: "The onus is on exchanges to develop commercial offerings that people want to use, and I don't think it's the right way for regulators to force inappropriate products on-exchange."



Jennifer M. Grigsby
 Senior Vice President,
 Treasurer and Corporate Secretary

May 28, 2009

Mr. Timothy F. Geithner
 Secretary of the Treasury
 1500 Pennsylvania Avenue, NW
 Washington, D.C. 20220

Dear Secretary Geithner:

Chesapeake Energy Corporation, the nation's largest independent producer of clean-burning, American natural gas, would like to thank the Administration for striving to achieve worthy goals of transparency, accountability and market efficiency in the over-the-counter (OTC) derivatives market. Following your recent proposals and those of federal lawmakers, we appreciate the opportunity to offer the following comments and proposals.

In your May 13, 2009, letter to Capitol Hill, you outlined the objectives for government regulation of the OTC derivatives markets following consultations with the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC) and other federal regulators. The goals were the following: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. As a company that extensively utilizes OTC commodity derivatives as a vital risk-management tool, **we also strongly support transparency, accountability, and market integrity.**

However, the letter goes on to say that "to contain systemic risks, the CEA (Commodity Exchange Act) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs)" with "robust margin requirements and other necessary risk controls and to ensure that customized OTC derivatives are not used solely as a means to avoid using a CCP. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCP, it should create a presumption that it is a standardized contract and thus required to be cleared."

Subsequent to reviewing the above proposal and others outlined in your letter, as well as legislation introduced in both the House and Senate (specifically, H.R. 977 by House Agriculture Committee Chairman Peterson and S. 272 by Senate Agriculture Chairman Tom Harkin), we have serious concerns about the impact these proposals would have on responsible, credit-worthy non-speculating end-user companies like Chesapeake Energy that hedge only the physical products we produce. Yet we also have areas where we support responsible reform to achieve the goals.

Chesapeake Energy Corporation Concerns

To begin, I would like to clarify several important points based on misconceptions we have heard.

Chesapeake Energy Corporation
 P.O. Box 18496 • Oklahoma City, OK 73154-0496 • 6100 N. Western Avenue • Oklahoma City, OK 73118
 405.879.9225 • fax 405.879.9576 • jennifer.grigsby@chek.com

- (1) First, it must be understood that the cash requirements of clearing OTC derivatives on an exchange would prove to be a significant liquidity drain on American companies that are using these contracts for prudent risk-management purposes. At a time when the U.S. economy needs more free-floating capital, posting cash margin on an exchange would prove to have the opposite effect, in fact, risking a more serious liquidity crisis. Chesapeake Energy invests more than 100 percent of our free cash flow into finding and producing clean-burning, American natural gas. The primary objective of our risk-management policy is to provide for cash-flow certainty and stability so we can responsibly plan and execute our future business strategy. A requirement to post cash would inject cash uncertainty into our business model and, thus, reduce our ability to explore for and produce natural gas.

For example, on June 30, 2008, our negative "mark-to-market," or what we owed our counterparties for natural gas hedging transactions, which were outstanding but not yet matured, was about \$6.3 billion. If our company had been forced to immediately fund such an enormous cash margin requirement, our company, which officially discovered what is known as the Haynesville Shale that same year, potentially the most significant natural gas field ever discovered in North America, would not have had the liquidity to invest in this new play. Additionally, by December 31, 2008, the natural gas market had reversed and our \$6.3 billion negative mark-to-market became a positive \$1.3 billion mark-to-market. In short, requiring cash to be posted on an exchange defeats the purpose of using OTC derivatives, which is to provide cash certainty for investing in the future.

- (2) Furthermore, we understand another significant concern about the OTC derivative market is that this market is unsecured. This is not the case for most end-users of these contracts. For example, on June 30, 2008, when Chesapeake owed about \$6.3 billion under our OTC derivative contracts, we had pledged collateral valued at more than \$11 billion to our derivative counterparties. The collateral we pledged included both letters of credit and mortgages on our oil and gas properties – our underlying business assets. While the security is not always in cash, our counterparties were and continue to be well-secured. This is how most end-users utilize this market and, as a result, help alleviate systemic risk.
- (3) Finally, there is a misconception that most OTC contracts are "standard" and can be easily housed on an exchange. However, an important feature of most OTC contracts is their ability to be "customized." Exchange-traded derivatives would not be able to be customized to offset our risks, therefore, the derivative would not precisely match the economics of the underlying risk being hedged. While OTC derivatives are not inherently complex products, their exact terms and conditions must be specifically customized to meet our needs, most importantly with respect to the accounting treatment governing our derivative contracts. Clearing requires standardization, and mandated clearing eliminates this essential ability to customize. Outside of the lack of economic offset, a standardized OTC contract would not meet stringent accounting rules, thus increasing near-term income statement volatility because of prudent longer-term risk-management policies. This "mis-match" could cause investors to be confused about financial results.

In short, as evidenced above, a company like Chesapeake Energy is merely an end-user of OTC derivatives. Companies like ours do not make the market, and we believe that forced

clearing ultimately will result in less end-user risk management and more volatility passed on to the consumer.

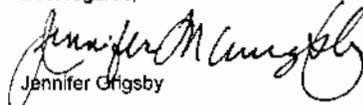
What We Support

There are important measures that Chesapeake supports. For instance, based on the proposals in your letter, we support the following initiatives and would be happy to discuss further:

- (1) First, **Chesapeake believes standardized trades between institutions (dealers, hedge funds, etc.) can be cleared**, addressing concerns about transparency and systemic risk without creating onerous, and at times unachievable, obstacles for end-users. We also believe determining what is "clearable" should be left to regulators, not clearinghouses.
- (2) Second, given concerns that the OTC derivatives market is uncollateralized or unsecured, **we recommend clear exceptions for clearing for end-users that protect their counterparties with ample and firm collateral**, such as – in our case – liens on our oil and natural gas properties.
- (3) We also support **counterparty reporting**, but not on a real-time basis, which is onerous and unnecessary to achieve the objectives of transparency. Additionally, we support reporting information to the general public on a regular basis.
- (4) Finally, **we support requirements to store all market information within a centralized warehouse** to facilitate access to information for regulators from a single source. Again, transparency and information-sharing are worthy goals, and we support both.

Thank you very much for your consideration, and we would be happy to expand further on any of the points in the letter and be a resource to you as a responsible end-user of OTC derivatives. Please contact Elliot Chambers at (405) 935-6119 or Sareh Gainer at (405) 935-4886 with any questions.

Best regards,



Jennifer Grigsby

CC:
 The Honorable Harry Reid
 The Honorable Nancy Pelosi
 The Honorable Mitch McConnell
 The Honorable John Boehner
 The Honorable Christopher Dodd
 The Honorable Tom Harkin
 The Honorable Saxby Chambliss
 The Honorable Barney Frank
 The Honorable Spencer Bachus
 The Honorable Collin Peterson
 The Honorable Frank Lucas

The Role of Speculation in the Recent Commodity Price Boom (and Bust)

by

Scott H. Irwin, Dwight R. Sanders, and Robert P. Merrin*

Written testimony submitted to the Senate Committee on Agriculture, Nutrition and Forestry –
June 4, 2009

* Scott H. Irwin is the Laurence J. Norton Chair of Agricultural Marketing in the Department of Agricultural and Consumer Economics at the University of Illinois at Urbana-Champaign. Dwight R. Sanders is an Associate Professor in the Department of Agribusiness Economics at Southern Illinois University, Carbondale, Illinois. Robert P. Merrin is a Ph.D. student in the Department of Finance at Universiteit Maastricht, Netherlands.

The Role of Speculation in the Recent Commodity Price Boom (and Bust)

Introduction

Led by crude oil, commodity prices reached dizzying heights during mid-2008 and then subsequently declined with breathtaking speed (see Figure 1). The impact of speculation, principally by long-only index funds, on the boom and bust in commodity prices has been hotly debated.¹ It is commonly asserted that speculative buying by index funds in commodity futures and over-the-counter (OTC) derivatives markets created a "bubble," with the result that commodity prices, and crude oil prices, in particular, far exceeded fundamental values at the peak (e.g., Ghcit, 2008; Masters 2008; Masters and White, 2008). The main thrust of bubble arguments is that: i) a large amount of speculative money was invested in different types of commodity derivatives over the last several years, ii) this 'titanic' wave of money resulted in significant and unwarranted upward pressure on commodity prices, and iii) when the flow of speculative money reversed the bubble burst. Based on the bubble argument, a number of bills have been introduced in the U.S. Congress with the purpose of prohibiting or limiting index fund speculation in commodity futures and OTC derivative markets.

The purpose of this paper is to show that the bubble argument simply does not withstand close scrutiny. Four main points are explored. First, the arguments of bubble proponents are conceptually flawed and reflect fundamental and basic misunderstandings of how commodity futures markets actually work. Second, a number of facts about the current situation in commodity markets are inconsistent with the existence of a substantial bubble in commodity prices. Third, available statistical evidence does not indicate that positions for any group in commodity futures markets, including long-only index funds, consistently lead futures price

changes. Fourth, there is a historical pattern of attacks upon speculation during periods of extreme market volatility.

Conceptual Errors

As noted in the introduction, bubble proponents argue that large investment flows, through index-type investments, resulted in unjustified upward pressure on commodity prices. Not only was the pressure unjustified according to bubble proponents, but it also caused very large overvaluations of commodities. For example, Fadel Gheit, Managing Director and Senior Oil Analyst for Oppenheimer & Co. Inc., made the following statement while testifying before the U.S. House of Representatives in June 2008:

"I firmly believe that the current record oil price in excess of \$135 per barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above \$60 per barrel... There were no unexpected changes in industry fundamentals in the last 12 months, when crude oil prices were below \$65 per barrel. I cannot think of any reason that explains the run-up in crude oil price, beside excessive speculation." (Gheit, 2008).

While bubble arguments may seem sensible on the surface, they contain conceptual errors that reflect a fundamental and basic misunderstanding of how commodity futures and OTC derivative markets actually work.

The first and most fundamental error is to equate money flows into futures and derivatives markets with demand, at least as economists define the term. Investment dollars flowing into either the long or short side of futures or derivative markets is not the same thing as demand for physical commodities. Our esteemed predecessor at the University of Illinois, Tom Hieronymus, put it this way, "...for every long there is a short, for everyone who thinks the price is going up there is someone who thinks it is going down, and for everyone who trades with the flow of the market, there is someone trading against it." (Hieronymus, 1977, pp. 302) These are

zero-sum markets where all money flows must by definition net to zero. It makes as much logical sense to call the long positions of index funds new “demand” as it does to call the positions on the short side of the same contracts new “supply.”

An important and related point is that a very large number of futures and derivative contracts can be created at a given price level. In theory, there is no limit. This is another way of saying that flows of money, no matter how large, do not necessarily affect the futures price of a commodity at a given point in time. Prices will change if new information emerges that causes market participants to revise their estimates of physical supply and/or demand. Note that a contemporaneous correlation can exist between money flows (position changes) and price changes if information on fundamentals is changing at the same time. Simply observing that large investment has flowed into the long side of commodity futures markets at the same time that prices have risen substantially (or the reverse) does not necessarily prove anything. This is more than likely the classical statistical mistake of confusing correlation with causation. One needs a test that accounts for changes in money flow and fundamentals before a conclusion can be reached about the impact of speculation.

It should be said that the previous argument assumes all market participants are equally informed. When this is not the case, it is rational for participants to condition demands on both their own information and information about other participants’ demands that can be inferred (“inverted”) from the futures price (Grossman, 1986). The trades of uninformed participants can impact prices in this more complex model if informed traders mistakenly believe that trades by uninformed participants reflect valuable information. An argument along these lines can be applied to the rise of index funds in commodity markets. It is possible that traders interpreted the large order flow of index funds on the long side of the market as a reflection of valuable private

information about commodity price prospects, which would have had the effect of driving price higher as these traders subsequently revised their own demands upward. Given the publicity that accompanied index fund entry into commodity futures markets and the transparency of their trading methods, it is highly doubtful that this happened on a wide enough scale in recent years to consistently drive price movements (more on this in a later discussion of noise trading).

The second conceptual error is to argue that index fund investors artificially raise both futures and cash commodity prices when they only participate in futures and related derivatives markets. In the short-run, from minutes to a few days, commodity prices typically are discovered in futures markets and price changes are passed from futures to cash markets (e.g., Garbade and Silber, 1983). This is sensible because trading can be conducted more quickly and cheaply in futures compared to cash markets. However, longer-term equilibrium prices are ultimately determined in cash markets where buying and selling of physical commodities must reflect fundamental supply and demand forces. This is precisely why all commodity futures contracts have some type of delivery or cash settlement system to tie futures and cash market prices together. Of course, delivery systems do not always work as well as one would hope (Irwin et al., 2008).

It is crucial to understand that there is no change of ownership (title) of physical quantities until delivery occurs at or just before expiration of a commodity futures contract. These contracts are financial transactions that only rarely involve the actual delivery of physical commodities. In order to impact the equilibrium price of commodities in the cash market, index investors would have to take delivery and/or buy quantities in the cash market and hold these inventories off the market. There is absolutely no evidence of index fund investors taking delivery and owning stocks of commodities. Furthermore, the scale of this effort would have

had to be immense to manipulate a world-wide cash market as large as the crude oil market, and there simply is no evidence that index funds were engaged in the necessary cash market activities.

This discussion should make it clear that it is wrong to draw a parallel (e.g., Masters and White, 2008) between index fund positions and past efforts to “corner” commodity markets, such as the Hunt brother’s effort to manipulate the silver market in 1979-80. The Hunt brothers spent tens of millions of dollars buying silver in the cash market, as well as accumulating and financing huge positions in the silver futures market (Williams, 1995). All attempts at such corners eventually have to buy large, and usually increasing, quantities in the cash market. As Tom Hieronymus noted so colorfully, there is always a corpse (inventory) that has to be disposed of eventually. Since there is no evidence that index funds had any participation in the delivery process of commodity futures markets or the cash market in general, there is no obvious reason to expect their trading to have impacted equilibrium cash prices.

A third conceptual error made by many bubble proponents, and unfortunately, many other observers of futures and derivatives markets, is an unrealistic understanding of the trading activities of hedgers and speculators. In the standard story, hedgers are benign risk-avoiders and speculators are active risk-seekers. This ignores nearly a century of research by Holbrook Working, Roger Gray, Tom Hieronymus, Lester Telser, Anne Peck, and others, showing that the behavior of hedgers and speculators is actually better described as a continuum between pure risk avoidance and pure speculation. Nearly all commercial firms labeled as “hedgers” speculate on price direction and/or relative price movements, some frequently, others not as frequently. In the parlance of modern financial economics, this is described as hedgers “taking a view on the market” (e.g., Stulz, 1996). Apparently, there is also some contamination in the non-commercial

category, with "speculators" engaged in hedging activities. This problem is highlighted in the recent Commodity Futures Trading Commission (CFTC) report on swap dealers and index traders, which included the statement that, "The current data received by the CFTC classifies positions by entity (commercial versus noncommercial) and not by trading activity (speculation versus hedging). These trader classifications have grown less precise over time, as both groups may be engaging in hedging and speculative activity." (CFTC, 2008b, p. 2)

What all this means is that the entry of index funds into commodity futures markets did not disturb a sterile textbook equilibrium of pure risk-avoiding hedgers and pure risk-socking speculators, but instead the funds entered a dynamic and ever changing "game" between commercial firms and speculators with various motivations and strategies. Since large commercial firms can take advantage of information gleaned from their far-flung cash market operations, it is not unreasonable to expect that these firms have a trading advantage compared to all but a few very large speculators.² The following passage from a recent article on Cargill, Inc. (Davis, 2009) corroborates this view of the operation of commodity futures markets:

Wearing multiple hats gives Cargill an unusually detailed view of the industries it bets on, as well as the ability to trade on its knowledge in ways few others can match. Cargill freely acknowledges it strives to profit from that information. "When we do a good job of assimilating all those seemingly unrelated facts," says Greg Page, Cargill's chief executive, in a rare interview, "it provides us an opportunity to make money...without necessarily having to make directional trades, i.e., outguess the weather, outguess individual governments."

This sheds an entirely different light on the entry of large index fund speculators into commodity futures and derivatives markets. Large hedgers are no innocents in this game and their economic interests are not easily harmed by new entrants.

Inconsistent Facts

In addition to logical errors, a number of facts about the situation in commodity markets are inconsistent with the arguments of bubble proponents. To begin, if speculation drove futures prices consistently above fundamental values, the available data indicates it was not obvious in the relative level of speculation to hedging. The statistics on long-only index fund trading reported in the media and discussed at Congressional hearings tend to view speculation in a vacuum—focusing on absolute position size and activity. As first pointed out by Working (1960), an objective analysis of futures market activity must consider the balance between speculators and commercial firms hedging market risks. A key insight from this framework is that speculation can only be considered ‘excessive’ relative to the level of hedging activity in the market.³

Weekly Commitments of Traders (COT) data provided by the CFTC are enlightening in this regard. Table 1 shows the division of open interest for nine commodity futures markets, averaged for the first three months of 2006 and 2008.⁴ The four basic hedging and speculative positions are: HL = Hedging Long = Commercial Long Positions; HS = Hedging Short = Commercial Short Positions; SL = Speculation Long = Non-Commercial Long + Index Trader Long Positions; SS = Speculation Short = Non-Commercial Short + Index Trader Short Positions. Note that index fund traders are allocated almost exclusively to the SL category in Table 1 and that $HL + SL = HS + SS$.⁵

As expected, Table 1 reveals that long speculation—driven by index funds—increased sharply in all but one of the nine commodity futures markets over January 2006 through April 2008.⁶ In four of the eight markets with an increase in long speculation (corn, soybeans, soybean oil, and cotton), the increase in short hedging actually exceeded the increase in long

speculation. Corn provides a pertinent example. Speculative buying in corn, which includes commodity index funds for this analysis, increased by nearly 250,000 contracts; but, selling by commercial firms involved in the production and processing of corn increased by an even greater amount, around 500,000 contracts. What this means is that long speculators (as a group) must have been trading with short hedgers. Working (1960) argued that this was beneficial to overall market performance since speculators provide liquidity and risk-bearing capacity for hedgers.

In the other four markets with an increase in long speculation (CBOT wheat, live cattle, feeder cattle, and lean hogs), the increase in short hedging was less than the increase in long speculation. Live cattle provides a pertinent example here. Speculative buying in cattle, again including commodity index funds, increased by nearly 70,000 contracts; whereas selling by commercial firms increased by only about 16,000 contracts. In this situation the bulk of the increase in long speculation had to be absorbed by an increase in short speculation. Working (1960, p. 210) argued that trading between speculators generally was “unnecessary” and reflected either, “entry into the market of a considerable group of inexperienced or ill-informed speculators” or “recognition by one group of speculators of significant economic conditions or prospects that are currently being ignored by other, equally expert and generally well-informed, speculators.” Either case could result in a deterioration of market performance. However, Sanders, Irwin, and Merrin (2008a) show that the observed increase in speculation for these markets was still well within historical bounds for commodity futures markets. Even higher levels of speculation have been observed in the past without adverse consequences for market performance.

In sum, observed speculative levels in commodity futures markets since early 2006, even after accounting for index trader positions, either did not exceed the hedging needs of

commercial firms or did not exceed historical norms for the level of speculation relative to hedging needs. Simply put, there is no compelling evidence that speculation was ‘excessive.’

The second inconsistent fact is that price movements in futures markets with substantial index fund investment were not uniformly upward through the spring of 2008. Panel A in Table 2 shows the increase in commodity futures prices over January 2006—April 2008 for the same nine markets as in Table 1. The spectacular price increases were concentrated in grain and oilseed markets, while prices in other markets either increased moderately or declined. It is especially interesting to note that prices either dropped or rose only slightly in the markets with the highest level of speculation relative to hedging (Table 1: live cattle, feeder cattle, and lean hogs). Figure 2 reveals the same pattern in a different form. Here the position of commodity index traders over time is plotted as a percentage of total market open interest. The highest concentration of index fund positions was often in livestock markets, the very markets without large price increases through the spring of 2008. It is difficult to rationalize why index fund speculation would have little or no impact in commodity futures markets with the highest concentration of index positions, relative to either hedging positions or total open interest, yet have a large impact in the markets with the lowest concentration.

The third inconsistent fact is that high prices were also observed in commodity markets not connected to index fund investment. Panels B and C in Table 2 provide four examples.⁷ Rough rice futures and fluid milk futures are not included in popular commodity indices tracked by index funds, but prices in these two markets increased 162% and 37%, respectively, over January 2006—April 2008. Apples for fresh use and edible beans do not have futures markets, and thus no index fund investment, yet prices in these markets increased 58% and 78%, respectively, over the same time interval. If index fund speculation caused a bubble in

commodity prices, why then did prices increase substantially in commodity markets without any index fund activity?

A fourth inconsistent fact has to do with inventories for storable commodities. Following Krugman (2008), Figure 3 illustrates market equilibrium for a storable commodity with and without a price bubble. The standard equilibrium occurs at the intersection of the supply and demand curves and results in a price of P_E . Now assume there is a bubble in the market that pushes price above equilibrium to P_B . At this inflated price the quantity supplied exceeds quantity demanded and the excess shows up as a rise in inventories. We should therefore observe an increase in inventories when a bubble is present in storable commodity markets. In fact, inventories for corn, wheat, and soybeans fell sharply over the last three years. Inventories of other commodities, such as crude oil, stayed relatively flat or declined modestly until very recently. The lack of a notable buildup in commodity inventories is one more reason to be skeptical that a large bubble developed in commodity futures prices.

A fifth inconsistent fact is the nature of commodity index trading. The literature on "noise traders" shows that a group of uninformed traders can consistently push prices away from fundamental value only if their market opinions are unpredictable, with the unpredictability serving as a deterrent to arbitrage (e.g., De Long et al., 1990). This notion seems unlikely given the ease with which other large traders can trade against index fund positions. Index funds do not attempt to hide their current position or their next move. Generally, funds that track a popular commodity index (e.g., Goldman Sachs Commodity Index) publish their mechanical procedures for rolling to new contract months. Moreover, they usually indicate desired market weightings when the index is re-balanced. So, the main uncertainty in their trading patterns

usually stems from overall in-flow or out-flows of monies associated with the underlying investment vehicle.

The problems created by the mechanical trading of index funds is well-illustrated by a recent story (Meyer and Cui, 2009) on problems experienced by the U.S. Oil Fund L.P., the largest exchange-traded crude oil index fund, when rolling positions from one nearby contract to the next:

"It's like taking candy from a baby," said Nauman Barakat, senior vice president at Macquarie Futures USA in New York. That candy comes out of the returns of investors in the fund. Take Feb. 6, when U.S. Oil moved its 80,000 contracts from March to April at the end of the trading day, selling the March contract and buying April. Because U.S. Oil publishes the dates of its roll in advance, traders knew the switch was coming. At 2 p.m., 30 minutes before closing, trading in New York Mercantile Exchange oil contracts soared, and the price of the April contract narrowed to \$4 more than the March contract. Within minutes, that gap had widened and closed at \$5.98, according to trading records. As the fund's managers were about to roll their contracts, "suddenly came the awfully extreme move," said one manager. Some said the move is a sign that big trades were placed ahead of U.S. Oil's roll. The price move instantly made it more expensive for U.S. Oil to roll into the April contract and cost the fund about \$120 million more than it would have a day earlier."

As the above passage so amply highlights, it is highly unlikely that other well-capitalized speculators, such as commodity trading advisors, hedge funds, and large floor traders, would allow index funds to push futures prices away from fundamental values when index trades are so easily anticipated.

A related point is that large and long-lasting bubbles are less likely in markets where deviations from fundamental value can be readily arbitrated away (easily "poached" in the terminology of Patel, Zeckhauser, and Hendricks (1991)). There are few limitations to arbitrage in commodity futures markets because the cost of trading is relatively low, trades can be executed literally by the minute, and gains and losses are marked-to-the-market daily. Moreover, the finite horizon of futures contracts further diminishes the likelihood that speculative arbitrage

is limited (Shleifer and Summers, 1990). This stands in contrast to markets where arbitrage is more difficult, such as residential housing. The low likelihood of bubbles is also supported by numerous empirical studies on the efficiency of price discovery in commodity futures markets (e.g., Zulauf and Irwin, 1998). Where pricing problems have been documented, they are typically associated with the delivery period of particular commodity futures contracts. However, as noted by the CFTC in a recent background memorandum on the application of its emergency powers, even this type of problem has only risen to an “emergency” level three times since the Commission was founded in 1974 (CFTC, 2008a).

Empirical Tests

The preceding discussion focuses on empirical facts that are inconsistent with substantial bubbles in commodity futures prices. When considered as a whole, these facts build a persuasive case against bubbles. However, the facts are largely circumstantial, since they tend to rely on indirect evidence. Bubble proponents can then argue that “this time is different” even if the links between commodity money flows and bubbles are not fully understood. This is an especially difficult argument to settle because the one variable that can provide definitive evidence about the level of commodity prices—fundamental value—is unobservable. It is like politics, everyone has an opinion.

While fundamental value is unobservable, all is not lost. It is still possible to conduct empirical tests of the hypothesis that money flows from index funds aided and abetted the recent boom and bust in commodity prices. This can be done by running standard Granger causality tests between futures price changes and position changes in commodity futures markets. These tests establish whether lagged position changes help to forecast current futures price changes.⁸

Sanders, Boris, and Manfredo (2004), Bryant, Bessler, and Haigh (2006), Gorton, Hayashi, and Rouwenhorst (2007), and Sanders, Irwin, and Merrin (2008b) conduct Granger causality tests using publically available data on positions of commercial, non-commercial, and non-reporting trader groups from the weekly COT report published by the CFTC.⁹ A typical set of results, drawn from Sanders, Irwin, and Merrin (2008b), is presented in Table 3. A statistically significant relationship between the movement of commodity futures prices and measures of position change is found in only 5 out of 30 cases. In other words, position changes by COT trader groups helps forecast futures price movements in only 16% of the cases, hardly more than what one would expect based on pure randomness. And the evidence is even slimmer if results are limited to non-commercial traders (speculators).

The previously cited studies cast considerable doubt on the value of position changes for any group in consistently forecasting futures price movements. However, these studies also use publically-reported COT data, which is aggregated across all contracts and reported only on a weekly or monthly basis. This may limit the power of Granger causality tests because positions cannot be matched precisely to contract maturity months and positions cannot be tracked over daily intervals. Some have argued that if speculator positions do impact returns it is most likely over time horizons shorter than a week (Streeter and Tomck, 1992).

The Interagency Task Force on Commodity Markets led by the CFTC recently conducted thorough Granger causality tests for the crude oil futures market using non-public data on the daily positions of commercial and non-commercial traders (ITFCM, 2008). Daily price changes and position changes for commercial and non-commercial traders, as well as various sub-groups of traders, were examined over January 2003—June 2008. Consistent with the findings in other studies, there was no evidence that daily position changes by any of the trader sub-categories

systematically led crude oil futures price changes over the full sample period. This result held for all categories of speculators tracked by the CFTC: non-commercial traders in total, hedge funds, swap dealers, and non-commercial traders combined with swap dealers. At least in the crude oil futures markets, Granger causality test results are unaffected by the use of daily versus weekly data or position changes for sub-groups of traders. This bolsters the findings from other studies that did not have access to such detailed data on trader positions.

Bubble proponents can still point out that none of the above referenced studies tested specifically whether commodity index trader positions help to forecast price movements over the last several years. In forthcoming work, Aulerich and Irwin (2009) provide just this type of evidence for 12 commodity futures markets. They conduct Granger causality tests using non-public data from the CFTC on the daily positions of commodity index traders over January 2000 through July 2008. A unique feature of this study is that the authors were able to extend the series on commodity index positions back through the entire sample under study for each of the 12 markets. Aulerich and Irwin found only a few cases where index trader position changes helped to forecast price changes in commodity futures markets. When significance was found the size of the estimated price impact was small. These findings also held when the sample was broken into sub-periods.

While it is always possible to dither over the power of Granger causality tests or whether specifications adequately control for changing fundamentals, the evidence to date leads to a high degree of skepticism that positions for any group in commodity futures markets, including index traders, consistently forecast futures price changes (this will not be true for skilled individual traders within a group).

Lessons from History

A pervasive theme running through the history of U.S. futures markets is skepticism or out-and-out hostility towards speculators (Jacks, 2007).¹⁰ Rapidly increasing or decreasing commodity prices at various times over the last 125 years have been accompanied by assorted attempts to curtail speculation or control prices. For example, just after World War II, soaring grain futures prices, especially for wheat, attracted political attention. President Truman proclaimed that, "the cost of living in this country must not be a football to be kicked around by grain gamblers," and ordered the Commodity Exchange Authority (precursor to today's Commodity Futures Trading Commission) to require futures exchanges to raise margins to 33% on all speculative positions, a truly extraordinary level. In a statement that echoes those being made today, President Truman added, "If the grain exchanges refuse, the government may find it necessary to limit the amount of trading."¹¹

In the boldest move against speculators in U.S. commodity futures, trade in onion futures was banned by the U.S. Congress in 1958. The ban, actually still in place, was due to the widespread belief that speculative activity created excessive price variation (Working, 1963). Again, in language very similar to that heard today, a Congressional report stated that "speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce."¹²

The experience of the last time period with a comparable level of structural change in commodity markets, 1972-1975, is particularly instructive. U.S. and international commodity markets experienced a period of rapid price increases from 1972-1975, setting new all-time highs across a broad range of markets. These price increases were often blamed on speculative

behavior associated with the "...tremendous expansion of trading in futures in a wide range of commodities" (Cooper and Lawrence, 1975, p. 702).¹³ Following these price increases, public and political pressure to curb speculation resulted in a number of regulatory proposals and the upward adjustment of futures margin requirements (Hieronymus, 1977; Rainbolt, 1977; Tomek, 1985). These changes were accompanied by even more drastic measures—such as federal price controls and an embargo against soybean exports—aimed at lowering commodity price levels.

The actions used to reign in supposedly damaging speculation in the past run the gamut from requiring futures exchanges to raise margins to an outright ban on futures trading. The historical evidence is thin, at best, that measures to limit the impact of speculation had the desired effect on market prices. For instance, there is no historical evidence that directives to increase futures margins were effective at lowering overall price levels. The only consistently documented impact of the higher margin requirements is a decline in futures trading volume due to the increased cost of trading (Fishe and Goldberg, 1986; Peck and Hudge, 1987; Haradouvelis and Kim, 1996).

Finally, it is important to note the historical pattern of attacks upon speculation. Petzel (1981, p. 117) commented that, "In periods of rising prices (e.g., the early 1920s, the Korean War, inflation, and the 1970s) grain speculators have been accused of increasing the prices of agricultural commodities artificially. During the early 1930s when agricultural prices were low, grain speculators were accused of depressing prices." Market cycles seem to be accompanied by a predictable pattern of speculative complaints: when prices are exceptionally low, natural sellers in the market, such as farmers, complain that speculators are the problem and when prices are exceptionally high, natural buyers in the market – consumers and processors – complain about speculators. While his focus was a relatively obscure episode in the 1925 wheat market, the

conclusion reached by Petzel (1981, p. 126) applies with equal force today, "...it is all too easy after suffering an economic loss to look for the villain in the piece. In 1925 the public found its villains and conspirators in the large speculators."

Conclusions

There is little evidence that the recent boom and bust in commodity prices was driven by a speculative bubble. If speculation by long-only index funds did impact commodity futures prices, it is not evident in the empirical evidence available to date. Economic fundamentals, as usual, provide a better explanation for the movements in commodity prices. The main factors driving prices up in the energy markets included strong demand from China, India, and other developing nations, a leveling out of crude oil production, a decrease in the responsiveness of consumers to price increases, and U.S. monetary policy (Hamilton, 2008). In the grain markets, factors driving up prices also included demand growth from developing nations and U.S. monetary policy, as well as the diversion of row crops to bio-fuel production and weather-related production shortfalls (Trostle, 2008). The favorable demand factors were reversed in quick order due to the recent financial market meltdown and burgeoning world-wide recession, leading to large price drops across-the-board in commodity futures markets (Good and Irwin, 2008). The complex interplay between these factors and how they impact commodity prices is often difficult to grasp in real-time and speculators have historically provided a convenient scapegoat for frustration with rapidly rising and falling prices.¹⁴

Legislative proposals currently being considered may in fact curtail speculation—through reduced volume of trade—but the initiatives could severely compromise the ability of commodity markets to accommodate the needs of firms to manage price risks. In particular, limiting the participation of index fund investors would rob the markets of an important source

of liquidity and risk-bearing capacity at a time when both are in high demand. The net result is that commodity futures markets will become less efficient mechanisms for transferring risk from parties who don't want to bear it to those that do, creating added costs that ultimately get passed back to producers in the form of lower prices and back to consumers as higher prices.

The recent attacks on speculation in commodity markets harkens back to an earlier era. For most of the past 30 years a consensus seemed to have been reached among policy-makers that speculation played a valuable and important role in commodity futures markets. Writing in the 1970s, Tom Hieronymus had this to say about the matter:

"For many years the anti-futures trading arguments tended to prevail so that speculation was treated as a necessary evil that accompanied the desirable hedging process. During the last decade the balance appears to have shifted so that a favorable view is more widely held. It is doubtful that the favorable view is yet in the majority but it is generally held by students of futures markets and increasingly held by members of Congress and the CFTC." (Hieronymus, 1977, p. 298)

Much to the surprise of agricultural economists, there is little doubt after the political uproar of the last year that a majority of the public still does not hold a favorable view of speculation. It is yet to be determined whether members of the U.S. Congress hold the same view and whether this portends a return to the anti-futures trading environment of an earlier era.

References

- Aulerich, N.M., and S.H. Irwin. "Direct Evidence on the Relationship between Daily Positions of Index Traders and Price Changes in Commodity Futures Markets." Paper to be presented at the NCCC-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management, St. Louis, Missouri, April 20-21, 2009.
- Bryant, H., D.A. Bessler, and M.S. Haigh. "Causality in Futures Markets." *Journal of Futures Markets*. 26(2006):1039-1057.
- Commodity Futures Trading Commission (CFTC). "CFTC Emergency Authority Background." Washington, D.C., 2008a. Available online:
<http://cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcemergencyauthoritybackgrou.pdf>.
- Commodity Futures Trading Commission (CFTC). "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations." Washington, D.C., 2008b. Available online:
<http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf>.
- Cooper, R.N., and R.Z. Lawrence. "The 1972-75 Commodity Boom." *Brookings Papers on Economic Activity* 3(1975):671-723.
- Davis, A. "Cargill's Inside View Helps It Buck Downturn." *The Wall Street Journal*, January 14, 2009. Available online:
http://online.wsj.com/article/SB123189501407679581.html?mod=rss_whats_news_us.
- De Long, J. B., A. Shleifer, L. H. Summers, and R. J. Waldmann. "Noise Trader Risk in Financial Markets." *Journal of Political Economy* 98(1990):703-738.

- Engelke, L., and J.C. Yuen. "Types of Commodity Investments." in *The Handbook of Commodity Investing*, F.J. Fabozzi, R. Fuss, and D. Kaiser eds., Hoboken, NJ: John Wiley and Sons, 2008, pp. 549-569.
- Fishe, R.P.H., and L.G. Goldberg. "The Effects of Margins on Trading in Futures Markets." *Journal of Futures Markets* 6(1986):261-271.
- Garbade, K.D., and W.L. Silber. "Price Movements and Price Discovery in Futures and Cash Markets." *Review of Economics and Statistics* 65(1983):289-287.
- Gheit, F. "Testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives." June 23, 2008. Available online: http://energycommerce.house.gov/crmtc_mtg/110-oi-hrg_062308.Gheit-testimony.pdf.
- Good, D., and S. Irvin. "Implications of Credit Market Problems for Crop Prices." Illinois Farm Economics Update 2008-03, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008. Available online: http://www.farmdoc.uiuc.edu/IFEU/IFEU_08_03/IFEU_08_03.pdf.
- Gorton, G.B., F. Hayashi, and K.G. Rouwenhorst. "The Fundamentals of Commodity Futures Returns." National Bureau of Economic Research (NBER) Working Paper No. 13249, July 2007.
- Grossman, S.J. "An Analysis of "Insider Trading" on Futures Markets." *Journal of Business* 59(1986): S129-S146
- Hamilton, J.D. *Time Series Analysis*. Princeton, NJ: Princeton University Press, 1994

- Hamilton, J.D. "Understanding Crude Oil Prices." Working Paper, Department of Economics, University of California-San Diego, 2008. Available online:
http://dss.ucsd.edu/~jhamilto/understand_oil.pdf.
- Hardouvelis, G.A., and D. Kim. "Price Volatility and Futures Margins." *Journal of Futures Markets* 16(1996):81-111.
- Hartzmark, M. L. "Returns to Individual Traders of Futures: Aggregate Results." *Journal of Political Economy* 95(1987):1292-1306.
- Hieronimus, T.A. *Economics of Futures Trading for Commercial and Personal Profit, Second Edition*. New York, NY: Commodity Research Bureau, 1977.
- Interagency Task Force on Commodity Markets (ITFCM). "Interim Report on Crude Oil." Washington D.C., 2008. Available online:
<http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf>.
- Irwin, S.H., P. Garcia, D.L. Good, and E.L. Kunda. "Recent Convergence Performance of CBOE Corn, Soybean, and Wheat Futures Contracts." *Choices*, 2nd Quarter, 23(2008):16-21.
 Available online: <http://www.choicesmagazine.org/magazine/article.php?article=26>.
- Jacks, D.S. "Populists versus Theorists: Futures Markets and the Volatility of Prices." *Explorations in Economic History* 44(2007):342-362.
- Krugman, P. "More on Oil and Speculation." *New York Times*, May 13, 2008. Available online:
<http://krugman.blogs.nytimes.com/2008/05/13/more-on-oil-and-speculation/>.
- Labys, W.C., and H.C. Thomas. "Speculation, Hedging and Commodity Price Behavior: An International Comparison." *Applied Economics* 7(1975):287-301.

- Masters, M.W. "Testimony before the Committee on Homeland Security and Government Affairs, U.S. Senate." May 20, 2008. Available online:
http://hsgac.senate.gov/public/_files/052008Masters.pdf
- Masters, M.W., and A.K. White. "The Accidental Hunt Brothers: How Institutional Investors are Driving up Food and Energy Prices." 2008. Available online:
<http://accidentalthuntbrothers.com/>
- Meyer, G., and C. Cui. "U.S. Oil Fund Finds Itself at the Mercy of Traders." *The Wall Street Journal*, March 6, 2009. Available online:
<http://online.wsj.com/article/SB123629874701846317.html>
- Patel, J., R. Zeckhauser, and D. Hendricks. "The Rationality Struggle: Illustrations from Financial Markets." *American Economic Review* 81(1981):232-236.
- Peck, A.E. "Reflections of Hedging on Futures Markets." *Food Research Institute Studies* 17(1979-80):327-349.
- Peck, A.E., and C. Budge. "The Effects of Extraordinary Speculative Margins in the 1947-48 Grain Futures Markets." *Food Research Institute Studies* 20(1987):165-180.
- Petzel, T.E. "A New Look at Some Old Evidence: The Wheat Market Scandal of 1925." *Food Research Institute Studies* 18(1981):117-128.
- Rainbolt, J.V. "Regulating the Grain Gambler and His Successors." *Hofstra Law Review* 6(1977):1-25.
- Sanders, D.R., K. Boris, and M. Manfredo. "Hedgers, Funds, and Small Speculators in the Energy Futures Markets: An Analysis of the CFTC's Commitments of Traders Reports." *Energy Economics* 26(2004):425-445.

- Sanders, D.R., S.H. Irwin, and R.P. Merrin. "The Adequacy of Speculation in Agricultural Futures Markets: Too Much of a Good Thing?" Marketing and Outlook Research Report 2008-02, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008a. Available online:
http://www.farmdoc.uiuc.edu/marketing/morr/morr_08-02/morr_08-02.pdf.
- Sanders, D.R., S.H. Irwin, and R.P. Merrin. "Smart Money? The Forecasting Ability of CFTC Large Traders." Working Paper, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008b. Available online:
<http://www.farmdoc.uiuc.edu/irwin/research/SmartMoneyCFTCTradersI.pdf>.
- Shleifer, A., and L.H. Summers. "The Noise Trader Approach to Finance." *Journal of Economic Perspectives* 4(1990):19-33.
- Stout, L.A. "Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives." *Duke Law Journal* 48(1999):701-786.
- Streeter, D. H., and W. G. Tomek. "Variability in Soybean Futures Prices: An Integrated Framework." *Journal of Futures Markets* 12(1992):705-728.
- Stulz, R. M. "Rethinking Risk Management." *Journal of Applied Corporate Finance* 9(1996):8-24.
- Tomck, W. G. "Margins on Futures Contracts: Their Economic Roles and Regulation." in *Futures Markets: Regulatory Issues*, A. E. Peck ed. Washington, D.C., American Enterprise Institute for Public Policy Research, 1985, pp. 143-209.

- Trostle, R. "Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices." Outlook Report No. WRS-0801. Economic Research Service, U.S. Department of Agriculture, May 2008. Available online: <http://www.ers.usda.gov/Publications/WRS0801/WRS0801.pdf>.
- Williams, J. *Manipulation on Trial: Economic Analysis and the Hunt Silver Case*. Cambridge, UK: Cambridge University Press, 1995.
- Working, H. "Speculation on Hedging Markets." *Food Research Institute Studies* 1(1960):185-220.
- Working, H. "Futures Markets Under Renewed Attack." *Food Research Institute Studies* 4(1963):13-24.
- Zulauf, C.R., and S.H. Irwin. "Market Efficiency and Marketing to Enhance Income of Crop Producers." *Review of Agricultural Economics* 20(1998):308-331.

Endnotes

¹ In reality, a variety of investment instruments are lumped under the heading "commodity index fund." Individuals may enter directly into over-the-counter (OTC) contracts with swap dealers to gain the desired exposure to returns from a particular index of commodity prices. Some firms also offer investment funds whose returns are tied to a commodity index. Exchange-traded funds (ETFs) and structured notes (ETNs) have also recently been developed to make it even easier to gain commodity exposure. ETFs and ETNs trade on securities exchanges in the same manner as stocks on individual companies. See Engelke and Yuen (2008) and CFTC (2008b) for further details.

² Hieronymus (1977) argued that large commercial firms dominated commodity futures markets and speculators tended to be at a disadvantage. Based on his theoretical analysis, Grossman (1986, p. S140) asserted, "...it should come as no surprise if a study of trading profit finds that traders representing large firms involved in the spot commodity (i.e., commercial traders) make large trading profits on futures markets." In the classic empirical study on this subject, Hartzmark (1987) showed that large commercial firms in six of seven futures markets make substantial profits on their futures trades.

³ Peck (1979-80, p. 339) provides a succinct re-statement of Working's argument, "Taken together, these analyses reaffirm the fundamental importance of hedging to futures markets and dependence of total activity upon hedging needs. The results also lend support to the Working definition of an appropriate measure of hedger demands upon a market. Net hedging is not the most useful view of the demands commercial users make on a market. Speculation is needed to offset both long hedging and short hedging. Only coincidentally are long and short hedgers

sufficiently alike in date and amount to be offsetting, although increased balance increases the probability of such correspondence and differences in seasonal needs between long and short hedgers decreases this probability. The appropriate measure of minimum required speculation must at least begin with total hedging demand.”

⁴ Note that total open interest consists of futures open interest and delta-adjusted options open interest.

⁵ Non-reporting trader positions are allocated to the commercial, non-commercial, and index trader categories in the same proportion as that which is observed for reporting traders (see Sanders, Irwin, and Merrin, 2008a).

⁶ There is an important omission from Table 1—crude oil futures. As the CFTC noted when it first began publishing data on index fund positions, it is difficult to separate out index fund transactions in energy markets because of the degree to which many firms in these markets engage in multiple trading activities that fall into different classifications and the degree to which firms engage in internal netting of these activities. The special swap dealer survey (CFTC, 2008b) does provide an estimate of index trader positions in the crude oil futures market; however, the data are limited to a six-month period from December 31, 2007 to June 30, 2008 and reported only on a net long basis. Computations for crude oil that parallel those reported in Table 1 can be made only by assuming that short positions for index funds are zero.

⁷ The four markets were not selected at random, but instead represent markets that generally have low-cross price elasticities relative to the nine markets in Panel A. If the selected markets had high cross-price elasticities, then observed price increases could have been due to linkages with

the markets in Panel A (and possibly bubble effects in these markets) rather than fundamental factors specific to the selected markets or fundamental factors common to all the markets.

⁸ Granger causality tests reflect the basic idea that if event X causes event Y , then event X should precede event Y in time. These tests require careful interpretation if the null hypothesis of no causality (no statistical prediction) is rejected (Hamilton, 1994). A statistical correlation may be observed between X and Y when in reality an omitted variable Z is the true cause of both X and Y . Hamilton (1994, p. 308) suggests it is better to describe “Granger causality” tests between X and Y as tests of whether X helps forecast Y rather than whether X causes Y . He notes that the tests may have implications for causality in the conventional sense, but only in conjunction with other assumptions.

⁹ In a work well ahead of its time, Petzel (1981) conducted Granger causality tests between the daily position changes of three groups of speculators and price changes for the May 1925 wheat futures contract at the Chicago Board of Trade. Foreshadowing later results, he did not find any evidence that lagged position changes helped to forecast current price changes.

¹⁰ See Stout (1999) for an in-depth discussion of the legal and regulatory history of opposition to speculation in the U.S.

¹¹ Quoted in Peck and Budge (1987, p. 172).

¹² Quoted in Working (1963, p.18).

¹³ It is fascinating to observe the similarity of the current public debate about speculation and the one that followed the mid-70s commodity boom. For instance, Labys and Thomas (1975, p. 287) motivate their paper with words that could have been written in 2008 instead of 1975, “This paper analyses the instability of primary commodity prices during the recent period of economic

upheaval, and determines the extent to which this instability was amplified by the substantial increase in futures speculation which also occurred. Of particular interest is the degree to which this speculation rose and fell with the switch of speculative funds away from traditional asset placements and towards commodity futures contracts.”

¹⁴ The origin of the word “scapegoat” is of more than passing interest in the present context. In ancient Israel, the high priest confessed all the sins of the children of Israel on the Day of Atonement over the head of a live goat. As a symbol of their sins, the goat was then sent into the wilderness to perish.

Table 1. Speculative and Hedging Positions (number of contracts) in Agricultural Futures Markets, First Quarter of 2006 and 2008

| Market | | HL | HS | SL | SS |
|---------------|--------|---------|-----------|---------|---------|
| Corn | | | | | |
| | 2006 | 328,362 | 654,461 | 558,600 | 208,043 |
| | 2008 | 598,790 | 1,179,932 | 792,368 | 182,291 |
| | Change | 270,428 | 525,471 | 233,768 | -25,752 |
| Soybeans | | | | | |
| | 2006 | 126,832 | 192,218 | 183,105 | 107,221 |
| | 2008 | 175,973 | 440,793 | 351,379 | 74,844 |
| | Change | 49,141 | 248,575 | 168,274 | -32,377 |
| Soybean Oil | | | | | |
| | 2006 | 66,636 | 124,134 | 92,515 | 35,599 |
| | 2008 | 121,196 | 228,515 | 128,546 | 25,844 |
| | Change | 54,560 | 104,381 | 36,032 | -9,755 |
| CBOT Wheat | | | | | |
| | 2006 | 57,942 | 213,278 | 251,926 | 92,148 |
| | 2008 | 70,084 | 240,864 | 300,880 | 121,578 |
| | Change | 12,141 | 27,585 | 48,954 | 29,430 |
| KCBT Wheat | | | | | |
| | 2006 | 43,993 | 110,601 | 80,158 | 13,560 |
| | 2008 | 46,459 | 96,556 | 67,827 | 15,767 |
| | Change | 2,466 | -14,045 | -12,330 | 2,207 |
| Cotton | | | | | |
| | 2006 | 41,582 | 108,085 | 86,777 | 21,824 |
| | 2008 | 107,826 | 296,434 | 200,773 | 18,918 |
| | Change | 66,244 | 188,349 | 113,995 | -2,906 |
| Live Cattle | | | | | |
| | 2006 | 54,549 | 128,951 | 129,786 | 45,305 |
| | 2008 | 34,970 | 144,549 | 198,211 | 80,303 |
| | Change | -19,579 | 15,599 | 68,425 | 34,998 |
| Feeder Cattle | | | | | |
| | 2006 | 10,707 | 17,725 | 20,769 | 10,632 |
| | 2008 | 6,310 | 13,435 | 28,284 | 18,111 |
| | Change | -4,397 | -4,290 | 7,515 | 7,479 |
| Lean Hogs | | | | | |
| | 2006 | 15,949 | 65,438 | 93,522 | 40,036 |
| | 2008 | 36,825 | 113,971 | 149,415 | 69,055 |
| | Change | 20,876 | 48,533 | 55,893 | 29,019 |

Notes: HL = Hedging, Long; HS = Hedging, Short; SL = Speculating, Long; SS = Speculating, Short. The data reflect average positions in the first calendar quarter of 2006 and 2008, respectively. Open interest is aggregated across futures and options, with options open interest delta-adjusted to a futures equivalent basis.

Source: Sanders, Irwin, and Mcrrin (2008a)

Table 2. Change in Commodity Prices, January 3, 2006—April 15, 2008

| Commodity | January 2006 | April 2008 | Change |
|---|---------------|---------------|--------|
| Panel A. Futures Markets Included in Popular Indexes | | | |
| Corn | \$2.20/bu. | \$6.06/bu. | 175% |
| Soybeans | \$6.28/bu. | \$13.80/bu. | 120% |
| Soybean Oil | 22.96¢/lb. | 62.52¢/lb. | 172% |
| CBOT Wheat | \$3.46/bu. | \$8.96/bu. | 159% |
| KCBOT Wheat | \$3.90/bu. | \$9.50/bu. | 136% |
| Cotton | 55.24¢/lb. | 75.23¢/lb. | 36% |
| Live Cattle | \$96.37/cwt. | \$91.57/cwt. | -5% |
| Feeder Cattle | \$114.00/cwt. | \$103.95/cwt. | -9% |
| Lean Hogs | \$64.65/cwt. | \$71.65/cwt. | 11% |
| Panel B. Futures Markets not Included in Popular Indexes | | | |
| Rough Rice | \$8.27/lb. | \$22.17/lb. | 168% |
| Fluid Milk | \$12.65/cwt. | \$17.29/cwt. | 37% |
| Panel C. No Futures Markets | | | |
| Apples Fresh Use | \$0.26/lb. | \$0.41/lb. | 58% |
| Edible Beans | \$19.30/cwt. | \$34.40/cwt. | 78% |

Notes: All prices refer to the relevant nearby futures price except apples and edible beans, which are monthly prices received by farmers.

Table 3. Granger Causality Test Results for CFTC Trader Categories, Positions Do Not Lead Returns, 1995-2006.

$$R_t = \alpha_t + \sum_{i=1}^n \gamma_i R_{t-i} + \sum_{j=1}^n \beta_j PNL_{t-j} + \varepsilon_t$$

| Market | P-values for Hypothesis Test: $\beta_j=0, \forall j$ | | |
|---------------|--|-----------------|---------------|
| | Commercials | Non-Commercials | Non-Reporting |
| Wheat CBOF | 0.01 | 0.18 | 0.54 |
| Wheat KCBOT | 0.03 | 0.24 | 0.71 |
| Wheat MGE | 0.63 | 0.15 | 0.76 |
| Corn | 0.35 | 0.79 | 0.33 |
| Soybeans | 0.83 | 0.05 | 0.78 |
| Soybean Oil | 0.24 | 0.30 | 0.94 |
| Soybean Meal | 0.70 | 0.93 | 0.61 |
| Lean Hogs | 0.05 | 0.34 | 0.08 |
| Live Cattle | 0.75 | 0.83 | 0.48 |
| Feeder Cattle | 0.10 | 0.16 | 0.23 |

Notes: R is the weekly return for nearby futures in the given market and PNL is the net long position of the trader group in percentage terms.

Source: Sanders, Irwin, and Merrin (2008b)

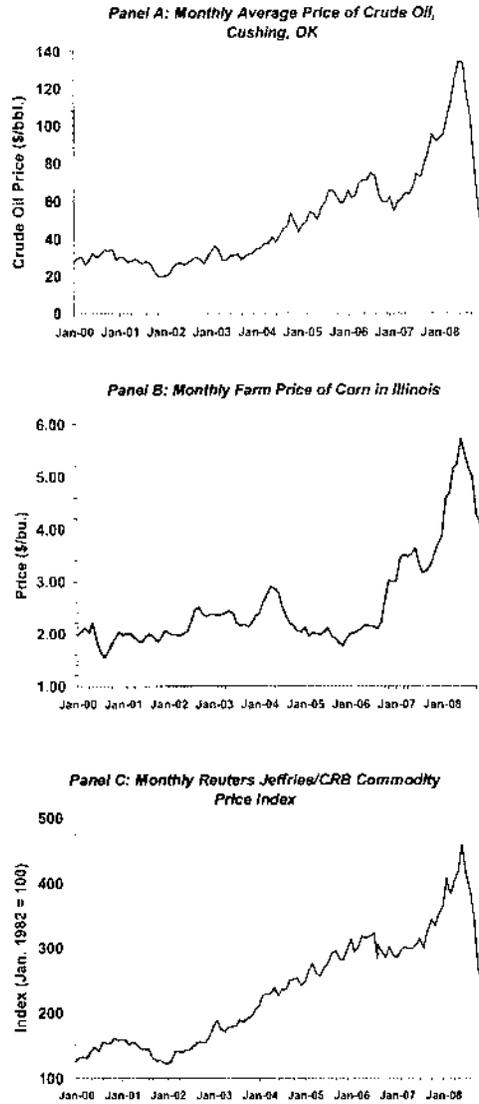
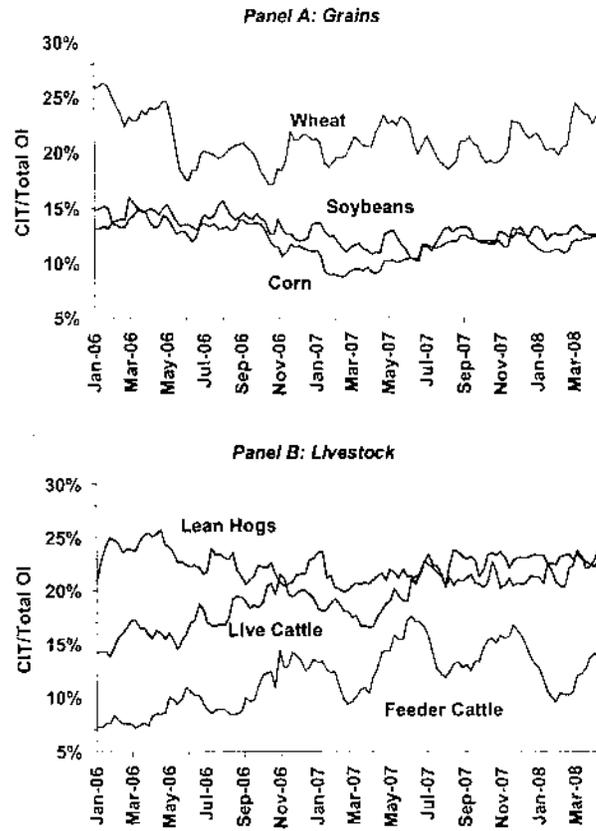


Figure 1. Selected Examples of the Movement of Monthly Commodity Prices, January 2000—December 2008



Note: Total open interest is aggregated across futures and options markets, with options open interest delta-adjusted to a futures equivalent basis.

Source: Sanders, Irwin, and Merrin (2008a)

Figure 2. Proportion of Open Interest Held by Commodity Index Traders (CITs) in Grain and Livestock Futures Markets, January 2006—June 2008

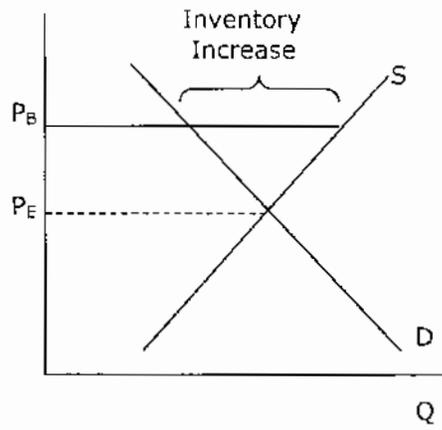


Figure 3. Theoretical Impact of a Price Bubble in a Storable Commodity Market



June 11, 2009

Committee on Agriculture, Nutrition and Forestry
 United States Senate
 328A Russell Senate Office Building
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

The Association for Financial Professionals (AFP) applauds the Chairman and Ranking Member of the Senate Committee on Agriculture, Nutrition, and Forestry for convening a thought-provoking hearing on the critical issue of regulations pertaining to derivative products. As the global daily resource and advocate for over 16,000 finance and treasury professionals in the United States, AFP maintains that derivative products are essential risk management tools that financial professionals rely on to help stabilize prices and mitigate risk. Our members support the enactment of legislation that encourages secure and transparent markets. However, AFP members have expressed concerns about the unintended consequences of proposals that require mandatory clearing of derivatives and futures products. We are concerned that regulations mandating the clearing of derivatives might negatively impact members' ability to enter into custom interest rate and foreign currency exchange swaps.

AFP members manage and safeguard the financial assets of more than 5,000 U.S. organizations. Our members are responsible for issuing short- and long-term debt and for managing corporate cash, 401(k) plans, and pension assets of their organizations. Many AFP members use interest rate and foreign exchange swaps in their daily business to mitigate risk for their organizations. We are concerned that inflexible regulation of the over-the-counter (OTC) derivatives market might negatively impact the sound and prudent practices of interest rate, foreign exchange swaps and ultimately make it impractical to use these products.

Specifically, many of AFP's financial accounting professionals have voiced concern over the possible conflicts between derivatives regulation, which may lead to the standardized contracts, and the strict hedge accounting rules imposed by the Financial Accounting Standard Board. Financial Accounting Standard 133 (FAS 133) requires a strict demonstration of the effectiveness of a given hedge, which would be impossible if customized contracts became prohibitively expensive or unavailable. With standardization, the ability to comply with the requirements of FAS 133 for applying hedge accounting treatment to swap transactions would become difficult, if not impossible. The net result of this change would be less hedging and more risks being borne by companies in an environment already marked by significant volatility.

Derivatives legislation is of great interest to AFP members for a variety of reasons important to the profession. Recently, AFP surveyed our members to assess the integration of risk management practices within their corporate culture and governance framework. Of all of the instruments used to manage financial risk, our research indicates that the vast majority of companies use over-the-counter forwards and swaps to mitigate that risk. 68% of the companies surveyed use interest rate swaps and 77% of the companies use foreign exchange swaps.

We also asked how the regulation of certain swap agreements would impact their use. In one example, a large health care company revealed that it relies on the ability to swap interest rates from floating to fixed in order to hedge interest rate risk. According to a senior treasury professional, if done correctly, "one can achieve hedge accounting treatment and all changes due to interest rate volatility will run through the balance sheet rather than income statement. This takes volatility out of the income statement and presumably out of the share price."

Another example revealed that a utility company uses swap agreements to hedge its expected future energy usage. A senior treasury executive shared that the company may purchase a contract to lock in the price of its future energy purchases. Under the short cut method, FAS 133 requires them to exactly match the terms and the dates of delivery and, if they do not match, the hedge is rendered ineffective, from an accounting perspective. Simply stated, if any aspect of

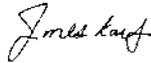
AFP Comments on Regulation of the OTC Derivatives Market
June 11, 2009
Page 2 of 2

the contract varies from the future purchase of energy, that variance would have to be reported on the income statement, which could cause significant volatility in the earnings of the company.

AFP applauds the efforts of the Senate Agriculture, Nutrition and Forestry Committee to bring transparency and stability to the OTC derivatives market, prevent excessive speculation, and secure derivatives markets. Our membership, experts on financial risk management for businesses across the United States, need interest rate swaps and foreign exchange swaps as essential tools for prudent risk management. Common practices already have banks playing a role similar to that of a clearinghouse, making these safe and secure transactions. As the Committee considers legislation on this issue we urge you to ensure that safeguards against abuse in the derivatives markets do not come at the cost of proven risk management tools that are critical to the stability of American businesses.

We thank the Committee and its members for its hard work and consideration of AFP's views on this matter. Please do not hesitate to contact AFP's Director of Finance Practice, Brian Kalish, at 301.961.6564 or bkalish@afponline.org, if you have further questions on AFP or our members' practices.

Sincerely,



James A. Kailz
President and CEO
Association for Financial Professionals

Cc: The Honorable Harry Reid, Senate Majority Leader
The Honorable Mitch McConnell, Senate Republican Leader
Members of the Senate Banking, Housing, and Urban Affairs Committee



COMMODITY MARKETS OVERSIGHT COALITION

June 3, 2009

The Honorable Nancy Pelosi
Speaker of the House
U.S. House of Representatives
H-212 Capitol Building
Washington, DC 20515

The Honorable John Boehner
Minority Leader
U.S. House of Representatives
H-204 Capitol Building
Washington, DC 20515

The Honorable Harry Reid
Majority Leader
United States Senate
S-221 Capitol Building
Washington, DC 20510

The Honorable Mitch McConnell
Minority Leader
United States Senate
S-230 Capitol Building
Washington, DC 20510

Dear Congressional Leaders:

Members of this coalition remain concerned that inadequate oversight of the commodities markets and excessive speculation will continue to erode public confidence in the ability of these markets to establish fair prices for energy, agricultural products and other commodities that are reflective of market fundamentals. We urge Congress to act decisively to bring full transparency to all trading environments and platforms, to prevent excessive speculation, and to close the door to potential manipulation.

2008 saw the most dramatic rise in commodities prices in history, resulting in inflated costs for energy and consumer goods in the United States. Internationally, millions of people were suddenly unable to feed themselves due to rising food commodity costs. Congressional hearings and reports revealed that inadequate or non-existent oversight of off-shore and over-the-counter (OTC) markets, ineffective oversight of on-exchange participants and activity, and an under-funded and under-staffed Commodity Futures Trading Commission (CFTC) had opened-the-door to excessive speculation and opaque trading activity. Additionally, members of this coalition voiced growing concern that passively-managed index funds, exchange-traded funds and actively traded hedge funds, swaps and derivatives were turning our commodity markets into a highly volatile "asset class."

We again urge the Congress to pass strong new legislation to restore our confidence in these markets as a risk management and price discovery tool for bona-fide commercial players.

Congress has taken some positive steps in the right direction, including last year's CFTC Reauthorization Act, which returns to the CFTC some authority over exempt commercial markets it had lost under the "Enron Loophole" in 2000. Appropriators have steadily increased CFTC funding levels in recent years to allow for much-needed staff, resources, and technology investments and we commend the President's FY2010 budget request of \$161 million. We commend the Senate for swift consideration of CFTC nominees, including the recently-confirmed Chairman Gary Gensler. We are also pleased that on May 13, 2009, President Obama announced his support for full transparency, accountability and oversight in the OTC markets.

Page 1 of 4

Commodity Markets Oversight Coalition
LETTER TO CONGRESSIONAL LEADERS
June 8, 2009

Coalition Contact
Jim Colura, New England Fuel Institute
jmcultura@nefi.com or (202) 594-0100

But absent strong and sweeping reform, we will continue to witness extreme price volatility and excessive speculation. Trading will continue to grow in "dark" or unregulated markets and investment speculators will continue to elude federal oversight, data reporting requirements and position limits. Families, businesses, farmers and laborers at home and abroad will continue to "pay the price" in many ways, including volatile and unpredictable energy, food and raw materials prices; impeding economic growth, development, investment, and job creation.

Therefore, we urge Congress to work swiftly and approve legislation that will:

- Address market activity for *all* commodities, including energy, agriculture, livestock and metals;
- Fully close the "Enron Loophole" by requiring that large over-the-counter trades comply with data reporting requirements and are made subject to speculative position limits;
- Close the so-called "Foreign Markets Loophole" or "London Loophole" by requiring the presence of foreign regulators with comparable oversight in order for an off-shore exchange to obtain regulatory exemptions (i.e., no-action letters);
- Close the "Swaps Loophole" by limiting hedging exemptions to *bona-fide* commercial participants and requiring that swap traders, index funds and institutional investors comply with all CFTC speculation limits and data reporting requirements;
- Limit exchange traded fund investments in physical commodities and their derivatives;
- Require across-the-board aggregate speculation limits to prevent traders from taking a controlling position in a commodity by taking large positions on multiple platforms;
- Require the CFTC to review all current regulatory exemptions and require Commissioners to withdraw them as appropriate or in accordance with existing or new authorities granted by Congress;
- Require a thorough review of all new and existing rules and regulations designed to protect market users and the public from fraud, manipulation and excessive speculation, including position limits, margin requirements, data reporting requirements, and public availability of data; and
- Require a thorough review of emerging environmental markets, emissions trading and related Wall Street products and instruments, including derivatives, index funds and exchange traded funds.

The ability to determine a fair price for commodities based on market fundamentals is vital to the success of recent efforts to address energy security, climate change, and the needs of the poor, low income and unemployed. It is essential to the welfare of farmers, truckers, laborers and small businesses, to new job growth and to the overall recovery of an economy that has been wounded by insufficient transparency and oversight of the financial services industry.

In recent weeks, energy commodities including natural gas, crude oil and refined petroleum products have been trading substantially higher despite record inventories and low demand. Internationally, some predict a tight food commodity market in the year ahead. According to a recent Barclays Capital survey, 79 percent of investors plan to increase holdings in these markets. Congress must do its part to help prevent another speculator-driven run-up in energy, agriculture, and other vital commodities.

Commodity Markets Oversight Coalition
 Letter to Congressional Leaders
 June 3, 2009

Coalition Contact:
 Jim Cellura, New England Fuel Institute
 jimcellura@neffi.com or (202) 584-0160

In both chambers of Congress, several bills have been introduced to address the issues discussed in this letter. It is our hope that members can work out their differences and, working with members of this coalition, move forward to pass strong and comprehensive legislation, put an end to excessive speculation and "dark market" trading, and restore confidence in our commodity markets.

Thank you for your consideration.

Sincerely,

Agricultural Missions, Inc.
 Agricultural Retailers Association
 Air Transport Association
 American Association of Crop Insurers
 American Cotton Exporters Association
 American Cotton Shippers Association
 American Public Gas Association
 American Trucking Associations
 Arkansas Oil Marketers Association
 Atlantic Cotton Association
 California Black Farmers and Agriculturalists Association
 Caney Fork Headwaters Association
 Colorado Wyoming Petroleum Marketers Association
 Columban Center for Advocacy and Outreach
 Congregation of Holy Cross
 Consumer Federation of America
 Consumer Watchdog
 Cumberland Countians for Peace & Justice
 Family Farm Defenders
 Florida Petroleum Marketers and Convenience Store Association
 Food & Water Watch
 Friends of the Earth US
 Fuel Merchants Association of New Jersey
 Gasoline & Automotive Service Dealer's of America
 Grassroots International
 Holy Cross International Justice Office
 Illinois Association of Convenience Stores
 Illinois Petroleum Marketers Association
 Industrial Energy Consumers of America
 Independent Oil Marketers Association of New England
 Institute for Agriculture and Trade Policy
 Justice and Witness Ministries, United Church of Christ
 Louisiana Oil Marketers & Convenience Store Assn.
 Maine Oil Dealers Association
 Mayknoll Office for Global Concerns
 Massachusetts Oilheat Council
 Mid-Atlantic Petroleum Distributors Association
 Missionary Society of St. Columban

Page 3 of 4

Commodity Markets Oversight Coalition
 Letter to Congressional Leaders
 June 9, 2009

Coalition Contact:
 Jim Colburn, New England Fuel Institute
 jim.colburn@nefi.com or (603) 594-0100

Montana Petroleum Marketers Association
 National Association of Convenience Stores
 National Association of Oil Heat Service Managers
 National Association of Truck Stop Operators
 National Catholic Rural Life Conference
 National Family Farm Coalition
 National Farmers Union
 National Latino Farmers & Ranchers Trade Association
 Nebraska Petroleum Marketers & Convenience Store Association
 Network for Environmental & Economic Responsibility, United Church of Christ
 New England Fuel Institute
 New Jersey Citizen Action Oil Group
 New Mexico Petroleum Marketers Association
 New Rules for Global Finance
 New York Oil Heating Association
 Ohio Petroleum Marketers & Convenience Store Association
 Oil Heat Council of New Hampshire
 Oil Heat Institute of Long Island
 Oil Heat Institute of Rhode Island
 Petroleum Marketers Association of America
 Petroleum and Convenience Marketers of Alabama
 Petroleum Marketers and Convenience Store Association of Kansas
 Petroleum Marketers and Convenience Stores of Iowa
 Platform ABC (Earth, Farmer, Consumer), Netherlands
 Public Citizen
 Quixote Center
 Ranchers-Cattlemen Legal Action Fund / ReCALF USA
 Rural Coalition/Coalición Rural
 Sisters of the Holy Cross Congregation Justice Committee
 Sisters of Notre Dame de Namur Justice and Peace Network
 Society of Independent Gasoline Marketers of America
 Southern Cotton Association
 Texas Cotton Association
 United Egg Association
 United Egg Producers
 Utah Petroleum Marketers and Retailers Association
 Vermont Fuel Dealers Association
 West Virginia Oil Marketers and Grocers Association
 Western Cotton Shippers Association
 Western Peanut Growers Association
 Wisconsin Crop Production Association
 World Cotton Exporters Association

cc: All members of the United States House of Representatives and the United States Senate
 The Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission
 The Honorable Michael Dunn, Commissioner, Commodity Futures Trading Commission
 The Honorable Walter Lukken, Commissioner, Commodity Futures Trading Commission
 The Honorable Jill E. Sommers, Commissioner, Commodity Futures Trading Commission
 The Honorable Bart Chilton, Commissioner, Commodity Futures Trading Commission

Page 4 of 4



Jay Timmons
Executive Vice President

June 3, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

The National Association of Manufacturers (NAM), the nation's largest industrial trade association, appreciates and supports the Administration's efforts to improve transparency, accountability and stability in the derivatives market. At the same time, we have some concerns about the proposed regulatory framework for over-the-counter (OTC) derivatives, released by the Treasury Department on May 13, 2009.

Manufacturers of all sizes use OTC derivatives to manage the cost of borrowing or other risks of operating their businesses, including fluctuating currency exchange, interest rates and commodity prices. The ability of commercial users to continue to use OTC derivatives is critical for mitigating risk and limiting damage to the balance sheets of American businesses, particularly during these unprecedented market conditions.

While we support initiatives to prevent excessive speculation and improve transparency and stability in the derivatives market, it is critical that policy makers preserve the ability of responsible companies to access critical OTC derivative products. Consequently, we are concerned about the following issues in the Treasury proposal:

- **Standardization:** A key benefit of OTC derivatives to commercial users is the ability of companies to customize derivatives to their specific risk management needs. Provisions that require the clearing of OTC derivatives would lead to the standardization of these tools, impeding the ability of companies to accurately hedge risks and comply with the requirements of Financial Accounting Standard 133 (FAS 133). Without the ability to hedge specific risks, companies would be forced to shoulder greater risks in an environment already marked by high volatility.
- **Cost of "Clearing":** Exchanges insulate commercial participants from credit exposure by requiring the value of the derivative contract (mark to market) to be posted in cash or Treasury securities and for market moves twice a day. The efficiency of clearing relies on high volumes of standardized products, characteristics that do not exist in the individual hedging transactions of the OTC market. Hedging in the OTC market is customized to fit the actual underlying risk on the value of the goods shipped and produced. The margin requirements associated with clearing would create an additional

Manufacturing Makes America Strong

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790 • (202) 637-3043 • Fax (202) 637-3182 • jtimmons@nam.org • www.nam.org

The Honorable Timothy F. Geithner
June 3, 2009
Page Two

administrative and liquidity burden for commercial users, resulting in additional financing and administrative costs.

- **Limited Dealers:** NAM members also are concerned about the potentially unintended consequence of reduced competition in the provision of OTC commodity derivative products, which would have a negative impact on end users. Any reform proposal should not create a monopoly in the OTC derivatives market for a certain group of dealers at the expense of the manufacturers who need to manage their risk. This would only increase prices, reduce transparency, and increase systemic risk.

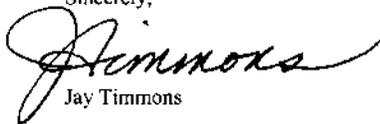
On a broader note, the NAM agrees with the Administration that the current financial crisis has exposed some areas in our financial regulatory system that should be addressed. Not all OTC derivatives, however, pose a risk to the financial system. We welcome the opportunity to work with policy makers to identify where increased, targeted oversight is warranted.

Similarly, while we understand the need for adequate reporting and record keeping, corporations already provide reports to the Securities and Exchange Commission (SEC) and other government agencies. We would like to work with policy makers on ways to set up a trade repository to enhance further transparency by pulling together information already required under existing reporting requirements.

In sum, NAM members believe strongly that any reform effort should ensure companies' continued access to OTC derivatives, providing them with greater financial certainty and allowing them to allocate resources to core business activities. Thank you in advance for considering our concerns. As this proposal moves through the legislative process, we look forward to working with you and members of Congress on legislation that encourages transparency and stability in the derivatives markets without sacrificing the ability of corporations to use these necessary tools.

With all best wishes, I remain,

Sincerely,



Jay Timmons

JT/gjj

QUESTIONS AND ANSWERS

JUNE 4, 2009

Chambliss for Chairman Gensler

1. You state in your testimony that swap dealers should be required to post capital and be subject to margin requirements. In his written testimony, Mr. Dines from Cargill states that "there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers." He goes on to discuss the inappropriateness of eliminating non-financial institutions as competitors. Do you feel that the regulatory regime you have outlined today for the regulation of dealers would in fact result in only financial institutions remaining as sell-side swap participants?
2. What information would CFTC find useful in a mandatory reporting regime? Would mandatory reporting for all transactions create more information than would be useful for regulatory analytical purposes? How would you structure mandatory reporting? Does the CFTC have the resources to analyze such a vast amount of data? Who do you feel should regulate the trade repositories you mention in your testimony, and do you envision one entity taking on this responsibility for all OTC transactions?
3. I gather from your testimony that you and I agree that the need for customized transactions requires us to find a way to make sure businesses can still use these vital risk management tools under this new regulatory regime. In your testimony, as Secretary Geithner did in his letter to the Congress last month, you state that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing. Do you feel that the clearinghouses are the most appropriate entity to determine if a contract is standardized?
4. You have proposed product standardization so that "OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another." Are you proposing that the best capitalized clearing houses with the strongest creditworthiness be forced to accept the credit and risk of dealing with potentially weaker clearing houses?
5. Given the fact that the vast majority of global futures and options markets do not permit fungibility and that existing OTC clearing facilities here and outside the U.S. also do not permit fungibility, how does your proposal ensure a level competitive playing field that allows U.S. clearing houses and exchanges the ability to compete?

Senator Pat Roberts
Senate Committee on Agriculture, Nutrition and Forestry
Questions for the Record
June 4, 2009

To Chairman Gensler:

1. What is your definition of "systemic risk?" How has this definition been applied to the financial bailouts? Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why propose treating all participants and products as if they do create a "systemic risk?"
2. The recent proposal by the Treasury Department for a systemic risk regulator calls for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?
3. How do you envision a systemic risk regulator will function in today's financial markets? What will be their primary role relative to the other regulatory agencies? Do you envision a regulator that would assume some of the duties of agencies such as OTS, SEC, and CFTC, and how do these authorities differ from the ones each currently possess independently?

To Mr. Dines:

1. How would the imposition of capital requirements for all dealers of OTC derivatives, as suggested by the Treasury Department's systemic risk regulator proposal, affect the OTC and derivatives markets and market participants? Would imposing such capital and licensing requirements drive non-financial intermediaries out of the derivatives market and if so what would be the economic effect of forcing manufacturers and other non-bank entities out of the commodities markets?

Senate Committee on Agriculture, Nutrition & Forestry
 Regulatory Reform and the Derivatives Markets
 Questions for the record
 Chairman Gary Gensler
 June 4, 2009

Senator Saxby Chambliss

- 1) You state in your testimony that swap dealers should be required to post capital and be subject to margin requirements. In his written testimony, Mr. Dines from Cargill states that “there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers.” He goes on to discuss the inappropriateness of eliminating non-financial institutions as competitors. Do you feel that the regulatory regime you have outlined today for the regulation of dealers would in fact result in only financial institutions remaining as sell-side swap participants?

Non-financial firms should be eligible to serve as swap dealers so long as they meet appropriate capital, margin, business conduct and reporting standards.

- 2) What information would CFTC find useful in a mandatory reporting regime? Would mandatory reporting for all transactions create more information than would be useful for regulatory analytical purposes? How would you structure mandatory reporting? Does the CFTC have the resources to analyze such a vast amount of data? Who do you feel should regulate the trade repositories you mention in your testimony, and do you envision one entity taking on this responsibility for all OTC transactions?

It is important that regulators be able to see both a particular trader's on- and off-exchange derivatives positions. Thus, derivatives dealers should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories would complement central clearing by providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the recorded information meets regulatory needs and that the repositories have strong business conduct practices. Trade repositories should collect and maintain the same data elements as the data collected for trades that are cleared. Based on the increased volume of information that would be received, the Commission would need to increase its resources devoted to the analysis and reporting of information.

- 3) I gather from your testimony that you and I agree that the need for customized transactions requires us to find a way to make sure businesses can still use these vital risk management tools under this new regulatory regime. In your testimony, as Secretary Geithner did in his letter to the Congress last month, you state that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing. Do you feel that the clearinghouses are the most appropriate entity to determine if a contract is standardized?

The determination of what is standardized should be made by regulators pursuant to criteria established by Congress. Whether a clearinghouse will accept a product, however, is an appropriate factor that should be included among such criteria.

- 4) You have proposed product standardization so that "OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another." Are you proposing that the best capitalized clearing houses with the strongest creditworthiness be forced to accept the credit and risk of dealing with potentially weaker clearing houses?

Arrangements should be established that facilitate open access to clearinghouses and foster competition amongst exchanges and trading platforms. Such arrangements should mandate that clearinghouses have rigorous risk management standards.

- 5) Given the fact that the vast majority of global futures and options markets do not permit fungibility and that existing OTC clearing facilities here and outside the U.S. also do not permit fungibility, how does your proposal ensure a level competitive playing field that allows U.S. clearing houses and exchanges the ability to compete?

Any fungibility arrangements should be designed to promote competition amongst clearinghouses and exchanges.

Senator Pat Roberts

- 1) What is your definition of "systemic risk?" How has this definition been applied to the financial bailouts? Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why propose treating all participants and products as if they do create a "systemic risk?"

Systemic risk is the danger that financial problems or failure at a firm will have serious repercussions across financial markets and the economy. I believe that we must enact comprehensive regulation covering OTC derivatives dealers and markets to help lessen such risk and promote market transparency. Capital, margin and business conduct

standards as well as mandated central clearing will help lower risk to the economy and American public.

- 2) The recent proposal by the Treasury Department for a systemic risk regulator calls for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

Capital requirements for OTC dealers would lower risk to the financial system and economy. Dealers with less risk exposure would have lower capital requirements. Both financial and non-financial companies could register as OTC dealers. End users of OTC derivatives would not have capital requirements, but would be required to post some type of collateral.

- 3) How do you envision a systemic risk regulator will function in today's financial markets? What will be their primary role relative to the other regulatory agencies? Do you envision a regulator that would assume some of the duties of agencies such as OTS, SEC, and CFTC, and how do these authorities differ from the ones each currently possess independently?

Though Congress may designate a regulator to oversee large financial institutions posing risk to the broad economy, I believe that responsibility for conducting market oversight would remain with the market regulators such as the CFTC or SEC.

Senate Committee on Agriculture, Nutrition & Forestry
Regulatory Reform and the Derivatives Markets
Questions for the record
Mr. David Dines
June 4, 2009

Senator Pat Roberts

- 1) How would the imposition of capital requirements for all dealers of OTC derivatives, as suggested by the Treasury Department's systemic risk regulator proposal, affect the OTC and derivatives markets and market participants? Would imposing such capital and licensing requirements drive non-financial intermediaries out of the derivatives market and if so what would be the economic effect of forcing manufacturers and other non-bank entities out of the commodities markets?
 - This is a very important question. Certainly, some level of capitalization seems appropriate, but it should be activity and risk-based. Non-financial dealers have an important role in the markets, and have managed their businesses such as not to require any tax payer assistance. More importantly, the markets with non-financial dealers, primarily the agricultural and energy markets, did not create systemic risk during the recent financial crisis.
 - We need to strike the right balance between having the right levels of capital and licensing requirements, and allowing these non-financial dealers to be able to continue to operate.
 - Removing non-financial bank intermediaries offers no advancement in reducing system risk, lessens competition and will likely result in more expensive risk management opportunities.

○

**GLOBAL WARMING LEGISLATION:
CARBON MARKETS AND PRODUCER GROUPS**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
SEPTEMBER 9, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

62-716 PDF

WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

PATRICK J. LEAHY, Vermont
KENT CONRAD, North Dakota
MAX BAUCUS, Montana
BLANCHE L. LINCOLN, Arkansas
DEBBIE A. STABENOW, Michigan
E. BENJAMIN NELSON, Nebraska
SHERROD BROWN, Ohio
ROBERT P. CASEY, Jr., Pennsylvania
AMY KLOBUCHAR, Minnesota
KIRSTEN GILLIBRAND, New York
MICHAEL BENNET, Colorado

SAXBY CHAMBLISS, Georgia
RICHARD G. LUGAR, Indiana
THAD COCHRAN, Mississippi
MITCH McCONNELL, Kentucky
PAT ROBERTS, Kansas
MIKE JOHANNIS, Nebraska
CHARLES E. GRASSLEY, Iowa
JOHN THUNE, South Dakota

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| Global Warming Legislation: Carbon Markets and Producer Groups | 1 |

Wednesday, September 9, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|----|
| Harkin, Hon. Tom, U.S. Senator from the State of Iowa, Chairman, Committee on Agriculture, Nutrition, and Forestry | 1 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 3 |
| Thompson, Hon. Mike, U.S. Representative from the State of California | 41 |

Panel I

| | |
|---|----|
| Gensler, Hon. Gary, Chairman, U.S. Commodity Futures Trading Commission, Washington, DC | 5 |
| Glace, Joseph R., Vice President for Risk Management and Chief Risk Officer, Exelon Corporation, Chicago, Illinois | 23 |
| Miller, David, Chief Science Officer, AgraGate, and Research & Commodity Services Director, Iowa Farm Bureau Federation, West Des Moines, Iowa ... | 26 |
| Profeta, Timothy, Director, Nicholas Institute for Environmental Policy Solutions, Duke University, Durham, North Carolina | 21 |
| Winkler, Julie, Managing Director, Research and Product Development, CME Group, and Member, Board of Directors, Green Exchange Venture, Chicago, Illinois | 28 |

Panel II

| | |
|---|----|
| Beckstoffer, W. Andy, Chairman and Chief Executive Officer, Beckstoffer Vineyards, Rutherford, California | 13 |
| Brubaker, Luke, Brubaker Farms, Mount Joy, Pennsylvania | 47 |
| Rehermann, Frank, Chairman, USA Rice Producers' Group, Live Oak, California | 15 |
| Yoder, Fred, Past President, National Corn Growers Association, Plain City, Ohio | 49 |

APPENDIX

| | |
|--------------------------------|-----|
| PREPARED STATEMENTS: | |
| Gillibrand, Hon. Kirsten | 58 |
| Grassley, Hon. Chuck | 68 |
| Thune, Hon. John | 62 |
| Beckstoffer, W. Andy | 65 |
| Brubaker, Luke | 71 |
| Gensler, Hon. Gary | 74 |
| Glace, Joseph R. | 81 |
| Miller, David | 90 |
| Profeta, Timothy | 106 |
| Rehermann, Frank | 116 |
| Winkler, Julie | 121 |
| Yoder, Fred | 132 |

IV

| | Page |
|--|------|
| DOCUMENTS SUBMITTED FOR THE RECORD: | |
| Brubaker, Luke : | |
| Darling International Inc., prepared statement | 140 |
| National Milk Producers Federation, prepared statement | 150 |
| QUESTION AND ANSWER: | |
| Harkin, Hon. Tom: | |
| Written questions for Andy W. Beckstoffer | 162 |
| Written questions for Luke Brubaker | 165 |
| Written questions for Gary Gensler | 171 |
| Written questions for Joseph Glace | 173 |
| Written questions for Dave Miller | 174 |
| Written questions for Timothy Profeta | 176 |
| Written questions for Frank Rehermann | 180 |
| Written questions for Julie Winkler | 184 |
| Written questions for Fred Yoder | 188 |
| Grassley, Hon. Charles E.: | |
| Written questions for Andy W. Beckstoffer | 163 |
| Written questions for Luke Brubaker | 168 |
| Written questions for Joseph Glace | 173 |
| Written questions for Dave Miller | 174 |
| Written questions for Timothy Profeta | 177 |
| Written questions for Frank Rehermann | 181 |
| Written questions for Julie Winkler | 186 |
| Written questions for Fred Yoder | 188 |
| Thune, Hon. John: | |
| Written questions for Andy W. Beckstoffer | 164 |
| Written questions for Luke Brubaker | 169 |
| Written questions for Gary Gensler | 171 |
| Written questions for Joseph Glace | 173 |
| Written questions for Timothy Profeta | 178 |
| Written questions for Frank Rehermann | 182 |
| Written questions for Fred Yoder | 189 |
| Roberts, Hon. Pat: | |
| Written questions for Luke Brubaker | 167 |
| Written questions for Frank Rehermann | 180 |
| Written questions for Fred Yoder | 188 |
| Beckstoffer, W. Andy: | |
| Written responses to questions from Hon. Tom Harkin | 190 |
| Written responses to questions from Hon. Charles E. Grassley | 191 |
| Written responses to questions from Hon. John Thune | 192 |
| Brubaker, Luke: | |
| Written responses to questions from Hon. Tom Harkin | 193 |
| Written responses to questions from Hon. Charles E. Grassley | 196 |
| Written responses to questions from Hon. John Thune | 197 |
| Written responses to questions from Hon. Pat Roberts | 195 |
| Gensler, Hon. Gary: | |
| Written responses to questions from Hon. Tom Harkin | 199 |
| Written responses to questions from Hon. John Thune | 199 |
| Glace, Joseph R.: | |
| Written responses to questions from Hon. Tom Harkin | 202 |
| Written responses to questions from Hon. Charles E. Grassley | 204 |
| Written responses to questions from Hon. John Thune | 205 |
| Miller, David: | |
| Written responses to questions from Hon. Tom Harkin | 207 |
| Written responses to questions from Hon. Charles E. Grassley | 207 |
| Profeta, Timothy: | |
| Written responses to questions from Hon. Tom Harkin | 213 |
| Written responses to questions from Hon. Charles E. Grassley | 214 |
| Written responses to questions from Hon. John Thune | 215 |
| Rehermann, Frank: | |
| Written responses to questions from Hon. Tom Harkin | 217 |
| Written responses to questions from Hon. Charles E. Grassley | 218 |
| Written responses to questions from Hon. John Thune | 219 |
| Written responses to questions from Hon. Pat Roberts | 217 |
| Winkler, Julie: | |
| Written responses to questions from Hon. Tom Harkin | 221 |
| Written responses to questions from Hon. Charles E. Grassley | 223 |

| | Page |
|--|------|
| Yoder, Fred: | |
| Written responses to questions from Hon. Tom Harkin | 225 |
| Written responses to questions from Hon. Charles E. Grassley | 226 |
| Written responses to questions from Hon. John Thune | 228 |
| Written responses to questions from Hon. Pat Roberts | 225 |

**GLOBAL WARMING LEGISLATION:
CARBON MARKETS AND PRODUCER GROUPS**

Wednesday, September 9, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 10 a.m., in room SH-216, Hart Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Conrad, Lincoln, Stabenow, Casey, Klobuchar, Gillibrand, Chambliss, Lugar, Johanns, Grassley, and Thune.

**STATEMENT OF HON. TOM HARKIN, U.S. SENATOR FROM THE
STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**

Chairman HARKIN. Good morning, and welcome to this hearing of the Committee on Agriculture, Nutrition, and Forestry on proposals for global warming legislation.

Senator Chambliss is on his way. We have to get started because we are up against kind of a time crunch here. This hearing will adjourn promptly at—no later than 12:30.

Our witnesses today will help us examine issues in structuring and regulating markets for greenhouse gas emission allowances. They will share the views of a cross-section of agricultural producers regarding the pending legislation.

Let me start by reiterating the urgency and importance of addressing global warming. I had a chart here that I keep using, if I can have it here again. I do not know if you can see it from the back. But as this chart shows, the concentration of carbon dioxide in the atmosphere has increased by about 50 percent over the last 150 years. We are now seeing the effects of that in rising global average temperatures. You can just see how rapidly it is going up increasingly from about 1980 on up at an ever increasing rate. And the ten warmest years on record, all occurred in the past 12 years. And just last week, Science magazine reported that temperatures in the Arctic are at the highest levels in the past 2,000 years.

In plain words, we humans are changing the Earth's climate. And while we do not know precisely all the consequences of our current climate trends, we do know they are likely to include more severe storms, more frequent and severe heat waves, in addition to rising seas and higher temperatures.

(1)

I agree with the majority of Americans who say that we must act to mitigate these effects. We must not simply leave future generations to cope with a hotter and more dangerous climate.

Our Committee began to consider the role of agriculture and forestry in reducing greenhouse gas emissions and the consequences of cap-and-trade at our first hearing in July. Today we will examine these issues at the farm level. We will hear from a corn and soybean farmer, a rice farmer, a grape grower and vintner, and a dairyman. In addition, we are obviously going to hear from the Chairman of the Commodity Futures Trading Commission at the outset to talk about the aspect of how these markets might be regulated by the CFTC.

Now, while we could not include representatives of every type of agriculture, I trust the testimony and discussions of these witnesses will begin to provide us with a better sense of on-the-ground effects that our agriculture sector is likely to see under global warming and under mitigation strategies.

We will hear from farmers and ranchers how they might benefit through actions such as the installation of digesters to reduce methane emissions from livestock production and other forms of methane emissions; cropping practices such as no-till farming or applications of biochar that increase carbon contents of soils; increased demand for renewable energy resources such as biofuels and wind power.

As the Committee with the responsibility for legislation governing commodity futures markets, the Senate is looking for our guidance on how to structure and regulate markets, and our first two panels will provide testimony on that issue.

If we are serious about a cap-and-trade system, we must get the trading part right, and that means effective, practical regulation and oversight so the markets work. The benefits of a cap-and-trade approach have been clearly stated: use the market system to reach the least expensive path to reducing greenhouse gas emissions. But the potential costs if these carbon markets blow up cannot be overstated. Markets that are not properly and carefully regulated will blow up, and the economy and environmental goals of the program will blow up with it. This market has the potential to be a very big and very complicated part with a lot of money at stake, and we have seen what can happen when there is not sufficient transparency, accountability, or limits on risky behavior in markets.

We should not put too much faith in the markets alone to deliver results. Do we want to repeat the adverse impacts of excessive speculation in the crude oil market last year for carbon? Do we want to replicate for allowances and offsets the free-wheeling derivatives market that helped bring down our economy?

We must avoid the dangers of excessive speculation or price volatility or so-called innovation that turns out to be all about short-term profit and simply creates greater risk instead of just managing the risk.

Some of the ideology and recklessness that helped drive our economy and our markets over the cliff are now surfacing in discussion of a cap-and-trade system. I find this troubling. We have learned a lot from years of both regulating commodities and previous cap-and-trade efforts from both regional and international carbon mar-

kets, and it is imperative that we incorporate those lessons into a properly regulated new carbon-trading regime.

In closing, I want to thank Senator Chambliss, thank you and all of your staff for the support in planning this hearing. I look forward to working with you as we outline the appropriate representation of agriculture and forestry as we provide guidance for the structure and regulation of greenhouse gas emissions allowances markets.

I would now turn to Senator Chambliss for opening comments.

**STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM
THE STATE OF GEORGIA**

Senator CHAMBLISS. Well, thank you, Mr. Chairman, and thanks for holding this second hearing on cap-and-trade and its effects on agriculture. In spite of the news I saw on TV this morning, I hope you are going to be holding many, many more agriculture hearings. Things do happen in politics, but you have been a great friend on this as well as every other issue involving agriculture.

I suspect that you and our colleagues on this Committee heard from many constituents, not just those involved in agriculture, over the August recess on cap-and-trade and climate legislation. I certainly did. It was clear to me that they want the Senate to very carefully consider all aspects of this issue and not rush to pass legislation.

I look forward to hearing from CFTC Chairman Gensler who has certainly jumped into the fray on a number of issues, and, Mr. Chairman, we appreciate your great leadership, your involvement, plus your continued dialog with the Hill. You committed to do that during your confirmation process, and I thank you for doing exactly what you said you were going to do.

Additionally, we will hear directly from those that will be regulated under a cap-and-trade system. Exelon, as an energy generator, will be required to purchase allowances and, therefore, deserves a workable risk management system within any newly created market. And CME Group, with its pending Green Exchange venture, will be subject to CFTC regulation as a designated contract market.

I expect any domestic carbon market would work much like existing commodity markets, though with a few notable differences. As the Committee with jurisdiction over commodity pricing and trading, we need to ensure we are fulfilling our responsibilities and weighing in with our colleagues on the issue of regulating any such carbon commodity market.

The issue of market regulation has not received the careful consideration that it justly deserves. To date, this Committee has focused its discussions on the impact on farmers and ranchers, and I am pleased that we will continue to hear about that important topic today.

As many of you know, the Texas A&M University's Agriculture and Food Policy Center recently released a report using its Representative Farms Data base to model the effects of the House climate bill on the farm level. For those of you here today who are not familiar with representative farm studies, they are commonly used in agriculture to model the effects of proposed legislation on

the micro level or at the individual farm level. The AFPC has been doing this type of work for Congress for more than 25 years. While the macroeconomic studies help Congress understand the effects of proposed legislation on agriculture as an industry, it is the representative farms that provide the ground truth of these proposals.

The ground truth that this study shows is very serious. The study says that 71 out of 98 farms will be worse off under the House cap-and-trade plan, even in the early years of the program. Most concerning, the 27 farms that benefit do so only because other producers go out of business. Not one rice farm or cattle ranch benefits, while only one cotton operation and one dairy benefit, mainly due to the fact that they both grow a significant amount of feed grains.

While intuitively we knew that there would be winners and losers in cap-and-trade, we did not know that the benefits and costs would be so disproportionate and regionally perverse. How can we as members of the Agriculture Committee endorse a policy that disproportionately favors certain commodities and, thus, only one part of the country at the expense of all others?

Mr. Chairman, I know you are very proud of your corn and soybean farmers in Iowa. You should be. But how can I reasonably support a bill that will put farmers in Georgia in a worse position or farms in California or farms in the Southwest, while transferring the benefits to the Corn Belt through attrition?

I look forward to hearing from the producer panel today with their thoughts on the House bill and the likely effects it will have on producers as reflected in this study. Given the complexities of the market issues and the negative effects likely to be felt by producers, Mr. Chairman, I think you were wise to plan for additional hearings. I hope our staffs can get together during this week and plan for the next hearing, and I thank you again and appreciate your leadership and your work on this issue.

Chairman HARKIN. Well, thank you very much, Senator Chambliss. Again, you are correct, we have to make sure that agriculture is treated fairly and equitably in this cap-and-trade legislation. I am committed to that. And we have to be cognizant of its varied impacts, depending upon what type of agriculture you are in and what part of the country you live in. And, hopefully, we will be able to address those and work those out as we move ahead on that. Obviously, we do not have jurisdiction over all that, but we will have jurisdiction over at least making our intents known to the Environment and Public Works Committee, I guess it is, before they start marking up.

We have a full panel today. As I announced earlier, we have to adjourn here by no later than 12:30. I am going to ask that each witness take 6 minutes. I am going to be—I have never been very strict on the gavel before, allowing people to go over, but I think we are going to have a lot of people who want to ask questions here today. So I am going to ask each of our panelists no more than 6 minutes at the maximum to discuss your papers. That will give us 54 minutes, and that will leave us about an hour and a half for questions. And I am going to ask for 5-minute rounds on questions also.

So we will start off with the Honorable Gary Gensler, Chairman of the U.S. Commodity Futures Trading Commission. Your statement will be made a part of the record in its entirety, as will all statements—and I read most of them last night—be made part of the record in their entirety. I would ask you just to sum up, as I said, in no more than 6 minutes.

Mr. Gensler, welcome again to the Committee, and please proceed.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. GENSLER. Thank you, Mr. Chairman and Ranking Member Chambliss. It is good to be back together with you and members of the Committee. My testimony will focus on the Commodity Futures Trading Commission's experience regulating emissions trading markets and how we can apply those experiences to trading in government-issued greenhouse gas allowances and offset credits. I am testifying on behalf of the full Commission, our four Commissioners, as I was glad to do the last time I was with you as well.

We believe that effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are five components that I believe should be considered: first, the standard setting and allocation, and, of course, the environmental compliance that goes along with that; second is recordkeeping, maintaining a registry for the allowances and offsets; third, overseeing trade execution systems; fourth, overseeing clearing of trades; and, fifth, protecting against fraud, manipulation, and other abuses.

Now, in terms of these first two components, those fall within the expertise of other agencies other than the Commodity Futures Trading Commission. In other words, there are others better equipped to regulate the "cap" part of cap-and-trade.

EPA, for example, currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain and Clean Air Market Acts. On a smaller scale, a group of ten States from Maryland up to Maine has the Regional Greenhouse Gas Initiative and issues allowances on greenhouse gas emissions. And in each of those cases, other entities issue the allowances, do the environmental compliance, and maintain the registry. The constant, however, in all of these markets is the CFTC currently regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the "trade" part of cap-and-trade.

We have broad experience in the latter three components of carbon trading: regulating the trade execution systems and clearing of trades and protecting against fraud, manipulation, and other abuses. The Commission already oversees this trading and clearing of emissions futures and options contracts of the New York Mercantile Exchange and the Chicago Climate Futures Exchange. Additionally, just last month, under direction from Congress in last year's farm bill, the Commission began looking into if the Carbon Financial Instrument spot contract traded on what is called the Chicago Climate Exchange, a sister exchange to the futures exchange, is actually a significant price discovery contract. So the

Commission has abundant experience in the regulation of centralized marketplaces, and should Congress seek to regulate cash markets for emission instruments, the Commission is well suited to carry out that function as well.

The Commission has thorough processes to ensure that exchanges and clearinghouses are in place to protect market participants and ensure fair and orderly markets, and that trading in these exchanges comply with the law and regulations. Our surveillance staff keeps a close eye on the signs of manipulation and congestion and determines how to best address, and we have the authority to set position limits as well within these markets.

The CFTC also has wide-ranging transparency initiatives, and it is designed to provide as much information to the American public as possible. So should you go forward with the cap-and-trade legislation, the CFTC would work with other regulators and market users to make sure that the transactions that occur—transactions that would have to be recorded on a registry kept by the EPA or USDA or others—that that registry be updated on a very real-time basis so that there would be market transparency.

The CFTC, however, if you were to move forward, would need additional resources. I fear that I keep saying this, but the staff and technology to effectively regulate the expanded carbon markets. We have the expertise. We would probably need some additional resources.

We also would want to work with Congress and look forward to working with Congress to enact broad, comprehensive reform of the over-the-counter derivatives marketplace. This reform must also include an oversight of the emissions and allowance markets if they were to develop in the over-the-counter space as well.

As Congress moves forward and possibly regulated cap-and-trade legislation, I look forward to working with this Committee to ensure that the new markets are comprehensively and effectively regulated. I believe the CFTC does have the expertise and experience necessary to help regulate the growth in carbon markets, and we must protect against the same hazards in the carbon markets that we currently guard against in other commodity futures markets, particularly fraud, manipulation, and other abuses.

I thank you for inviting me here today. I look forward to your questions. I did it in 4 minutes.

[The prepared statement of Mr. Gensler can be found on page 74 in the appendix.]

Chairman HARKIN. That is perfect. Thank you very much, Chairman Gensler, and I will say that we will have just 5-minute rounds. Again, I hope that we will respect each other's time on that and try to limit it to 5 minutes, and I will start off and start my clock at 5 minutes.

Chairman Gensler, two things I want to ask. If we have a cap-and-trade system for greenhouse gas emissions, is there really a need for an over-the-counter market? And, second, I am concerned about derivatives. If we allow trading of derivatives on greenhouse gas offsets and allowances, would it make sense to require at the end date of a future or other derivative contract that there be a transfer of the actual offset or allowance, not simply a cash settlement?

I ask both those questions because of my concern about derivatives on offsets or allowances and then derivatives on those derivatives and derivatives on those derivatives, and we are right back where we started before. And so I repeat: Is there a need for an over-the-counter market? And, second, should there at some point near the settlement date be some delivery of the actual offset or allowance and not simply a cash settlement?

Mr. GENSLER. Mr. Chairman, I appreciate your question. It continues a dialog we have had before in these hearing rooms. I believe that all futures on these carbon markets should be on exchanges, just as we have all futures for corn and wheat and oil and natural gas on regulated exchanges, and we are equipped to do that. I believe working with Congress, we need to make sure that any—what is currently called over-the-counter derivatives or swaps on these are brought under regulation, that the dealers in carbon markets, just like the dealers in oil or in wheat markets, should be fully regulated for capital and so forth; and that the standard contract should also be brought on exchange rates, standard swap contracts for these carbon allowances.

But I do believe that there are going to be times where there is going to be tailored product that cannot readily be brought onto a centralized clearing. An example might be that if you wanted to build a utility in Iowa or in Georgia or in any one of your States, and that utility wants to bring on a financing for 10 years or even 20 years, you might want to lock in—that utility might want to lock in the price of the carbon emissions out 10 and 20 years, and that might not be readily available on a market.

I do believe, though, working with Congress, that contract too should be under regulation by making sure that the dealer who is transacting that has to have the capital, has to report it to the regulators, the EPA and possibly other regulators regulating the cap side, and also to the regulators regulating the trading side as well.

Chairman HARKIN. How do we control the possible proliferation of derivatives on greenhouse gas emissions and the speculation thereon?

Mr. GENSLER. Well, I think as we are working with Congress to bring the whole over-the-counter derivatives marketplace under regulation, we must do that here as well; that the dealers in these contracts must be regulated for transparency, 100 percent of their transactions, whether they be tailored or standardized; but also if you were to move forward and ask the CFTC to regulate that, that we be able to set aggregate position limits across those traded in the futures market as well as those in what might be in this tailored or still bilateral market.

Chairman HARKIN. One last thing. I hope that you and the other Commissioners and your staffs will continue to monitor what is being done here—not here, but in the Congress—so that at the appropriate time, when this legislation looks like it is mature and is ready to go to the floor, that we could get from you what resources you would need to carry out the provisions of the bill in order to provide adequate oversight and regulation.

Mr. GENSLER. We will do that, Mr. Chairman, and I commit to work with you and the appropriators to share that with you.

Chairman HARKIN. I just want to make sure they just do not dump on your lap all this stuff without the resources that you would need to regulate and have this oversight.

Mr. GENSLER. Thank you.

Chairman HARKIN. Thank you, Mr. Chairman. Thank you, Chairman Gensler.

Senator Chambliss?

Senator CHAMBLISS. Thank you, Mr. Chairman. And let me just echo that, Mr. Chairman, because you and I have talked before about the fact that I think you are underresourced right now for what you have been charged to do; and I think you are finding that out every day you go to the office. So we need to make sure as we go through the whole financial overhaul, restructuring that we do not load you up with something else that would prevent you from being able to do your current job.

I want to continue along that same line. I understand what you are saying about seeking to regulate all of these contracts and put them all on exchanges, but we know that today where the only cap-and-trade market that is functioning is in Europe, about 75 percent of contracts are traded over the counter. If they have been at this for a while and they are trading that high a percentage over the counter, what are we going to do different to try to bring those contracts onto the exchange?

Mr. GENSLER. Senator, I believe that you are right to look—Europe does give us some guidelines as to what might happen here. There are actually three marketplaces. There is the futures marketplace, where actually in Europe that market is all on exchange, the futures. There is a cash marketplace, and I think that is what you refer to. Some of that is off-exchange, of course.

If I could say it here, if a farmer in Iowa wanted to transact and sell an offset to another farmer in Iowa or maybe in Georgia, they might do that over the counter.

Third, there is the swaps or derivatives marketplace. I believe that we have to have 100 percent of the futures marketplace regulated, just as we do in corn and wheat and oil. I believe that we have to have the standard derivatives contracts onto exchanges, as we are trying to do with Congress in other contracts as well, and that leaves the question on the cash markets. Can one farmer transact with another farmer? And I think that is probably appropriate. But if a centralized market comes together, I think we have to regulate that centralized market to protect against fraud and manipulation. These election trading platforms should have oversight and regulation, I believe.

Senator CHAMBLISS. Does the proposal by the administration that has come forward from Treasury, and while it is not firm yet by any means—and I know you have some issues with it. We have some issues with it. But the proposal that is out there, does that, do you think, give you the appropriate power to regulate the carbon contracts also? Or are we going to have to make some changes in that?

Mr. GENSLER. I believe that the administration sent up to Congress a very strong package and that that package actually, to your question, does cover in the definitions of swaps contracts on emissions, allowances, and offsets. If it does not, we will have to tweak

it, along with Congress, but the intent was, working with Treasury, that it did cover that.

Senator CHAMBLISS. Let us talk for a minute about this issue of standardized versus specialized contract, and we have got the same issue, obviously, out there today with a number of other commodities. But is there going to be any difference in trying to say that a contract on a carbon emission is a standardized contract if it does so-and-so versus an interest rate contract that is standardized if it does so-and-so? Where are we going to come down on this? And how are we going to define "standardized"?

Mr. GENSLER. I think it is very similar. What the administration put forward, and I support, is that the biases toward bringing more transparency and lowering risk that standardized products are on exchanges or trading platforms and centralized clearing, if a clearinghouse accepted a carbon allowance swap to be cleared, then the presumption would be that it would be standardized.

That still might be the case that if somebody has to finance a 10- or 20-year utility plant, they could do that. But most likely the 1-year, the 2-year, or the 3-year carbon allowance trading would be largely standardized—maybe not entirely, but largely standardized.

Senator CHAMBLISS. OK. Just in addition to staying in touch with us relative to the resources, I think this issue is going to be critical with respect to the markets you have jurisdiction over now as well as any carbon contracts. And it is another reason I think we better be careful as we move ahead with cap-and-trade to make sure we get it right, and that if we are going to clear all of these contracts, with few exceptions—and I agree with you, I hope we can do that—we need to make sure that the traders out there on both sides of these contracts really have some direction. And I think we have got to be very careful that we give them the right kind of language to know what it is they are going to be dealing with.

Mr. GENSLER. Senator, I agree, and I also think you have highlighted the intersection of Congress' work between cap-and-trade and over-the-counter derivatives reform. These two legislative initiatives might be timed a little differently and through different committees at times, but they very much relate in the regards you just said.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss. Senator Klobuchar was next, she is not here. Then we turn to Senator Grassley, Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman. Thank you, Mr. Gensler.

In your testimony, you state that emissions contract markets operate no differently than other commodity markets that CFTC regulates. However, there are members of the following panel that say these markets are quite different because the market is mandated by a Government-imposed cap and the market is ever reducing supply. So would you please reconcile these two points of view that the market really is different, but should be regulated in a uniform way as other commodities?

Mr. GENSLER. There are many similarities, like in the agricultural products this Committee oversees and their futures in corn

and wheat. There is an annual crop in a sense. There is an annual crop of allowances that are issued. It may be reducing instead of growing. Hopefully we think of corn and wheat growing, and this might be reducing.

It has some similarities to even Treasury bonds. Treasuries are issued by the Government. These are issued. Again, we would like to think that there would be fewer treasuries, but, unfortunately, there seems to be more every year. So there are many similarities.

Where the similarities depart—I would certainly look forward to working with this Committee and Congress to see if there is additional oversight we would need. But I think in terms of overseeing a trading market, there are far more similarities than there are differences to all the other products that are overseen, whether it be the agricultural, the energy, or the financial products that are currently overseen in the futures markets.

Senator GRASSLEY. Next, you mention briefly in your testimony about the recent public hearings that CFTC held on whether to set position limits on energy markets like we do in agriculture markets. Expand for me and the Committee on your findings at the hearings.

Mr. GENSLER. We had three hearings where we had 23 witnesses, and we had over 400 comment letters that came in. What we are looking at is Congress really directed in our statute that the CFTC set position limits—this was back in the 1930's—and we did so in agricultural products and still do so. We did in energy products with the help of the exchanges through June of 2001. And, in fact, it was just 8 years ago that we sort of backed away from that, and the exchanges now have what is called accountability levels rather than hard limits.

So we are taking a very close look as a Commission at this, all the comments, the thought really being that markets—how do we best promote a market, the fair and orderly market that no one party is so highly concentrated in that market that actually by being so large in the market, it sort of distorts a market and limits liquidity and limits the market function rather than adds to the market?

It is a lot to move forward, but if we were to move forward—and I say “if” because we have a Commission process—we are looking to do that in the fall with proposed rules. We would take more public comment through the usual means that we do that.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman HARKIN. OK. Thank you.

Senator Klobuchar?

Senator KLOBUCHAR. Thank you very much. Thank you, Chairman.

Over 25 years ago, Minnesota was the first State in the Nation to adopt legislation to address acid rain, and since then, as you know, President George H.W. Bush in 1990 created the Acid Rain Emissions Trading Program. And so our country has had some experience with this, and I know this is an emissions program that is regulated by the EPA. However, the CFTC has oversight of emissions trading. Could you comment about how that is working and any analogies you can draw with the proposals before us?

Mr. GENSLER. Senator, I thank you. I did not know it was your home State that started that.

I think it has worked well. It is a small market, and much smaller than these anticipated markets. But under the Acid Rain and Clean Air Act, two products—sulfur dioxide and nitrogen oxide—are limited, and that is all done by the EPA. There is no offset program. It is more an allowance program. But then there are futures trading on these various contracts, and they are traded on something called the Chicago Climate Futures Exchange, and then also there is, I will call it NYMEX, or New York Mercantile Exchange, has—and I think you have a witness later today about that.

Those futures trade. They are under our current regulatory regime. So far there has not been any issues that are not similar to the other things that we oversee to protect against fraud manipulation. We oversee the clearing and the exchanges on these.

Senator KLOBUCHAR. And do you think it has been a success, the trading on that?

Mr. GENSLER. I think that the trading—I am not going to speak to the environmental side, which I have read a lot about, but it is other expertise. I think the trading has brought greater price discovery, that those participants in the market who want to transact, have a broad national market; that natural hedgers, just like in corn and wheat and oil, have somebody on the other side who might take the other side, who is a speculator but is setting a price with them to ensure that outcome.

So I think in that regard, yes, it has been a success. It is still a very small market, of course.

Senator KLOBUCHAR. OK. So you think you could draw some knowledge and wisdom from that, but that this would be a much bigger project to tackle?

Mr. GENSLER. I think that is right.

Senator KLOBUCHAR. OK. And how does it compare with what is happening with the EU and how the EU has handled it?

Mr. GENSLER. Well, in Europe, you are right to mention that they, too, have gone forward, but they have a greenhouse gas initiative. They have two contracts, two trading—one is on the allowances, the EU allowances, and one is on emissions reductions or what we here call “offsets.” And those two contracts trade very actively on the European Climate Exchange and on something called Bluenext, two different exchanges. One is regulated by a French financial regulator, the other by the U.K. regulator.

The open interest there, interestingly, is about the size—I just looked at it last night—about half a million contracts on the European Climate Exchange, which is about the size in open interest in corn or wheat, which are about 300,000 or 400,000 contracts. It is about a third of the size of WTI oil, which is about a million and a half open interest, just to give you a sense of the size of that market.

Senator KLOBUCHAR. OK. Since you have mentioned wheat a few times—and this is a little different topic—in January, the GAO issued a report in response to House Ag Committee Chairman Collin Peterson, who is a Minnesota Congressman, and he asked the GAO to examine issues surrounding the regulation of futures trading, as you know. And once noteworthy aspect of the report

was the conclusion that eight empirical studies generally found limited statistical evidence of a causal relationship between speculation in the futures market and changes in commodity prices. A recent report by Homeland Security revealed that speculation was, in fact, one of the major causes behind the recent fluctuations in wheat.

So could you comment on these reports and the connection between speculation and volatility of commodity prices?

Mr. GENSLER. We have recently—I think it was just last week—promoted greater transparency in these markets by disaggregating our weekly reports. We now also break out the index investors in the market. I think that the best role for the CFTC is to help promote transparency so market analysts can best answer the Senator's question.

I do think as it relates to wheat specifically, if I can narrow that, I do think that index investing in the wheat contract in Chicago—and it is a very narrow topic—probably did contribute to what is called a lack of convergence in the wheat market. That is, the price of futures and cash in the wheat market has not come together. And so I think a little bit over half of that marketplace in the Chicago wheat market is index investors, and I think that is one of the contributing—not the only factors, but contributing factors to the lack of wheat convergence.

Senator KLOBUCHAR. Thank you very much.

Chairman HARKIN. Thank you.

Now Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman, and welcome, Chairman Gensler.

Mr. GENSLER. Good to be back in front of you.

Senator STABENOW. It is good to see you. Just as one member, I would indicate, and speaking to our appropriations leaders, that if we move forward on cap-and-trade, we certainly need to address resources to make sure the CFTC is able to fully address all of the issues involved in this, which are incredibly important.

I wanted to follow up more on the over-the-counter issue, which I think is a very important piece of all of this, and not only as we look at reforms that we are addressing here in this country, but in the House bill they would allow U.S.-covered entities to use international carbon instruments by the EU, the emissions trading system, or the UN's Clean Development mechanism to meet our domestic compliance purposes.

So given that approximately 75 percent of all the emission trading in Europe takes place over the counter, how do you see commonizing international carbon instrument compliance if the U.S. legislation were to restrict such instruments for compliance purposes to those traded on regulatory markets?

A second question would be, as a follow-up: Has the CFTC conducted an analysis of what impacts, if any, the administration's Over-the-Counter Derivatives Markets Act of 2009 would have on the domestic and international carbon markets?

Mr. GENSLER. Well, in the first question, I think that international cooperation is critical. I do not know where Congress will come out in terms of whether those allowances or offset allowances

over in Europe will be allowed here. But even if they are not, there is going to be some relationship of these two marketplaces.

I believe that we have to have full transparency even into the over-the-counter market. The over-the-counter swap market may still be allowed, but it should be fully regulated. We should have the transparency. Any dealer in those markets should be registered, and we should have 100 percent transparency into that, and we should report the aggregate positions.

In terms of the second question about the over-the-counter reform that has been proposed by the administration, it does include oversight of the carbon allowance markets. We have not had a separate study of that because it is such a small part, it is a small market in nitrogen oxide and in sulfur dioxide. There is a small market also between ten States, in New England down to my home State, Maryland, called the Regional Greenhouse Gas Initiative. But, again, it is small. We have not had an independent study yet.

But I do think that if we move forward, we must cover carbon allowances in what is being considered in the over-the-counter derivatives legislation that the administration sent up.

Senator KLOBUCHAR. So, just to recap, you are not seeing a problem in between what is happening internationally and at least at this point what the House bill has said in terms of using—allowing the international emissions standards versus what we are doing here? I mean, harmonizing that, would you have any recommendations as it relates to that?

Mr. GENSLER. My recommendation would be if an allowance or an offset there is fungible into a U.S. system, if the Congress decides that it is fungible, then we want to make sure, just as oil is fungible worldwide, that we are looking at the aggregate markets, that we would have to be working even more closely with the FSA currently overseas and then there is a French financial regulator that oversees those trading markets over there. So fungibility puts a greater burden—this fungibility is a global fungibility of offsets. It puts a greater burden on the regulators to have a coordinated approach.

Senator KLOBUCHAR. And do you feel confident that you can achieve that?

Mr. GENSLER. I think we can, but it is a greater challenge because sometimes they have a different point of view than we do on how to regulate these markets.

Senator KLOBUCHAR. All right. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Stabenow.

Now Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and, Chairman Gensler, thank you for your appearance again. You have appeared in front of many Senate committees, and we are grateful you are here again.

I am going to give you a little commercial in a moment, but I wanted to, first of all—that is because of your Pennsylvania connections, by the way, but I also want to commend your work. But we are here today to talk about a challenge that faces not just our country but the world, and the basic challenge is how to slow, stop, and reverse global warming. Obviously, there is legislation that is in the House, and the Senate is working on this as well. As we do

that, we have to be able to balance and take into serious consideration and implement strategies within the legislation to make sure that our farm families are not adversely impacted. I believe, though, by as much as it is a challenge, it is an opportunity. It is an opportunity not just to stop global warming and keep our environment clean, but it is also a jobs opportunity, to create jobs and also to enhance our national security.

We know that rural America, the families in rural America have been hammered by this recession. In fact, some of them were adversely impacted long before the recession with the high energy costs. Senator Gillibrand and I were just talking about our dairy farmers, all across States like Pennsylvania and New York and so many others, that have been adversely impacted.

We are grateful today that you are here. We are grateful for your work in restoring confidence and giving a sense of strategy and a sense of purpose to the work that you do as a regulatory body that needs, as I realize, more resources.

I know that later today we will hear from, among others, Luke Brubaker from Pennsylvania, and he was kind enough to provide some Pennsylvania crop insurance advertising. We are grateful for that, and we are grateful it was on the top of the pile of our papers. I want to thank him on behalf of the people of Pennsylvania.

Senator KLOBUCHAR. Would you like one?

Senator CASEY. Senator Klobuchar is passing out extra copies.

But that all leads back to you because I know you are a Wharton graduate. We are pretty proud of you, and we hope you come back to Pennsylvania and live and pay taxes and do all that.

[Laughter.]

Senator CASEY. But in the meantime, you have got a lot of work to do here in Washington.

I was especially impressed by and happy about the fact that in your testimony you said—I am looking at page 2. You said, and I quote, “As Congress moves forward with... cap-and-trade legislation, I believe it should ensure that there is a comprehensive regulatory framework over the expanded carbon markets...” I think those are very important words, “comprehensive regulatory framework.” And then later, on page 6, you emphasized ensuring that “all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis.” And all of the concerns that you have raised about how we do this to get it right and to be able to regulate it.

I will ask in the very limited time that I have left, because I know I have talked for a couple of minutes here as a preface, but in terms of your resources, both human, staff resources as well as technology, tell us about what you need to do your job generally, but also in particular, if legislation is passed to give you this additional assignment, so to speak. What would you need specifically or as best you can guess in terms of people and resources? And on the technology part of it, is it both hardware, software, and other aspects of technologies?

I know it is a broad question, but you have all of a minute to answer.

Mr. GENSLER. Well, I thank you, and I appreciate the advertisement. If there is anything you like in what I do, you can credit it

to my University of Pennsylvania education. Anything that you do not like, you could credit to my wayward days elsewhere.

[Laughter.]

Mr. GENSLER. But in terms of needed resources, with Congress' help we have just gotten back to the size we were in 1999, about 570 people. We are going to submit, the Office of Management and Budget, to Congress in, I think, a week's time a much larger number, but it is going to be what we really believe we need to do our current duties. In technology, it is mostly software upgrades. We need to take our position and trading surveillance systems, probably spend on the order of \$11 or \$12 million, but we do not know—it is probably a multi-year project—to upgrade that to 21st century surveillance rather than right now it is too much after-the-fact surveillance.

Senator CASEY. Well, thank you very much, and, Mr. Chairman, both Chairman Gensler and I have been very careful on our time, so I will stop right here. Thank you.

Chairman HARKIN. Thank you very much, Senator Casey.

Senator JOHANNIS?

Senator JOHANNIS. Thank you, Mr. Chairman. Let me, if I might, start my questions with maybe a little bit of context. In our last hearing with the Agriculture Committee, I asked a question of one of the panelists, Lisa Jackson. If we do what the House bill wants us to do, what will the environmental benefit be? Will temperatures come down? Will we reduce CO2 emissions in the world? And the answer was no. You know, going it alone is not going to change much. Then soon after that, India and China weighed in, and they basically said, "We are not interested in capping emissions." So we are asking our farmers and ranchers to bear the burden of this when, quite honestly, I would find it very hard to make a claim to them that we are going to see really any environmental benefit.

Second, although there is some debate about the nature and extent of this, it is a given that they are going to have higher input costs. Now, like I said, we can have a great debate as to whether diesel fuel is going to go up X versus Y and this and that, but I think it is a given that they will pay higher input costs.

Now, I put that together with this notion that we have had in agriculture, especially as a result of the 2002 farm bill, that really what we are trying to do with agriculture is take some of the volatility out of it. We talked about the safety net and the loan deficiency program, the marketing loan program, the countercyclical program, the ACRE program. All of those are designed to kick in at a point where we take some of the volatility out of it.

You know, farming is one of those businesses: They cannot pick their price; they cannot predict the weather; they cannot predict what kind of pests they are going to deal with, and on and on. So it is a very, very difficult situation anyway.

Here is what worries me about your piece of this puzzle. I do not think there is anything that we could do that would guarantee that in the trading here that is going to occur that there is not going to be volatility. We might be able to define, to some extent, what the parameters of that are going to be. But it just seems the nature of this that there is going to be volatility.

Now, I think the Ranking Member made some excellent points. As I read the Texas A&M study, there are more losers than winners on this in agriculture. And even in the two farms from Nebraska that they analyzed, those are dryland farmers, and in Nebraska we irrigate. I think they would have been on the losing side of the equation because of higher electricity costs.

So my question to you is: How much should farmers and ranchers be worried about the volatility, the additional volatility that this cap-and-trade legislation is going to put into their lives? And how much does this bill prevent that from happening?

Mr. GENSLER. Senator, I think that you are right, as you said, that farmers and ranchers cannot pick the price, cannot predict the weather, and so forth. I think that what we can do moving forward with Congress is make sure that if you move forward, the trading side is most transparent so the farmers and ranchers can see that pricing; that if they want to hedge it, they can hedge it out a long time; and that the price that they get is created in a market that is free of manipulation and it is fair and orderly. That is our remit at the CFTC, is to make sure that price discovery is fair and orderly, it is transparent, and the farmer can hopefully hedge their risk out, you know, on a yearly or multi-year basis.

Senator JOHANNIS. Here is the difficulty of that if you are a farmer, and I will use the turkey industry as a good example. When corn went to \$6.50, \$7, it wiped out the turkey industry in Nebraska. Just wiped them out. So if you have higher prices and you end up with that kind of situation with higher input costs, it will be zero consolation to that farmer when I call them and say, "I am sorry you went broke because of this thing, but it was transparent." Do you see what I am saying?

Mr. GENSLER. No, I mean, I see what you are saying. I am just addressing what we do well as a market regulator is assuring that there are markets that are not only transparent, but the price discovery function—and this is also for farmers or ranchers that would be having offsets and they wanted to sell those offsets, too, and get the benefit of a price that way as well, as a revenue, that that market is free from manipulation on the trading side of cap-and-trade.

Senator JOHANNIS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Johannis.

Let us see. Senator Conrad was next. Senator Gillibrand?

Senator GILLIBRAND. Thank you, Mr. Chairman.

Mr. Gensler, thank you so much for being here. We are extremely grateful for your testimony and your leadership on these issues. I have basically three areas of inquiry that I hope you can address.

The first is about the regulatory structure. I want to know your opinion on whether we should develop a regulatory structure for carbon trading that is distinct from other commodities, or would that, in fact, be more detrimental to the goal of providing effective market regulation and make it more difficult for the CFTC to do their job—enforce position limits, protect against fraud, and other regulatory objectives? So, basically, I would like your opinion on which regulatory structure you think is best and would be most effective?

Second, I want you to address a little bit more specifically about the clearing process. Equity and equity options are handled through an open format, and the multiple exchanges competing for business generally can bring down costs for both clearing and settlement, and it has had that effect over recent years.

Clearing for commodities remains a closed system that lacks any competitive dynamic, and as a result, the costs are higher associated compared to equity and equity options contracts.

So, in your opinion, is it better to create a new model utilizing a noncompetitive model? Or would you prefer to do a more open competition, open access market? Which do you think is more effective, and why?

Then the third issue is a little bit about over-the-counter and customized markets, what you would recommend? If we did have a customized market, an over-the-counter market, what would you recommend for that? And, in particular, do you believe it is appropriate to exempt anyone, particularly end users with bona fide hedges, from the mandate of everything having to go through clearing or an exchange? And do you think it would be appropriate and enforceable to exempt firms with inherent carbon risk—for example, utilities producers—from such a mandate?

So, essentially, do you imagine or would you recommend any trading of customized markets for the carbon exchange that would not necessarily have to go through clearing or not through an exchange rate, depending on what we choose? And then, second, if you do imagine an exception, what kind of regulatory oversight would you imagine? Because, clearly, you would want to have transparency and the regulators would need to know volume. But what would you imagine for the regulatory aspect of that piece?

Mr. GENSLER. Let me see if I can try to address all three of your questions and some of the subparts. It is good to be back with you, Senator.

In terms of regulatory structure, I think that the Commodity Futures Trading Commission does have the expertise and experience, does currently oversee the futures markets, albeit small, in emissions for these out of the acid rain program and even the regional alliance that I think both of our home States are in. So I think that is a good structure. We have two market regulators in this country. I am not sure we need a third market regulator. There is enough that we can harmonize between the SEC and the CFTC.

I think that in terms of clearing you raise a very good point. We have actually recommended for over-the-counter derivatives that we have an open model for clearing. We think that that will promote greater competition amongst exchanges and exchange platforms, and certainly I think it is worthy to think about that in terms of the carbon markets. We would certainly recommend that for the carbon over-the-counter derivatives marketplace, but you raise a question about carbon futures, which is a worthy question. Right now it is a more closed approach on the Chicago Climate Exchange, I believe, but I might be mistaken on that.

Now in terms of over-the-counter markets, I think that it is important to bring as much of the over-the-counter market into centralized clearing and onto exchanges as possible. Some will not be able to be standardized, of course. You raise a second question as

to whether, if there was a hedge that is entered into for accounting purposes, it is a bona fide hedge—I think, if I read into your question, might that be treated a little differently? The administration proposal was to grant the SEC and CFTC some rule-writing authority in that regard to allow some of that to be exempted.

I do have a concern that the more we exempt, the more that we might be years from now looking back at 2009's Enron loophole or something. So I think we have to be very careful in each of these categories in terms of exemptions, because we want end users to manage their risk appropriately, these tens of thousands of end users, but I think society also needs to lower the overall risk by bringing as much into central clearing as possible.

Senator GILLIBRAND. So if there is a customized market left, what would you have it look like? And who would be eligible—

Mr. GENSLER. Well, I think there will be a customized market, both in carbon markets as well as interest rate products and elsewhere. But I think the dealers in those markets have to be fully regulated so that the customized transactions and the standard transactions, the dealers would have to have capital; there would be business conduct to protect against fraud and manipulation so we could police the markets along with the SEC on the other products. These products would probably be more ours, oversight, and then the transparency, that not only as regulators we saw it, but we could aggregate the data and put it out to the public.

Senator GILLIBRAND. Thank you.

Chairman HARKIN. Thank you, Senator Gillibrand.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, and thanks for holding the hearing today. Welcome, Chairman Gensler. We are glad you are back.

Mr. GENSLER. Good to see you again.

Senator LINCOLN. I would like to associate my comments with the Senator from Pennsylvania, Senator Casey, in terms of the challenges that we face, but the opportunities that we can find there. And I think there are great opportunities here.

I also want to associate my comments with him in terms of making sure that as we do move forward, we do not do so putting a disproportionate burden on our hard-working farm families and our agricultural communities across this country. They do a tremendous job providing food and fiber for the world, and I hope that as we look at what we are trying to do, we will keep that in mind always.

While it is not necessarily my preference to move on cap-and-trade legislation in the Senate this year, if the Senate is going to move on climate change legislation in the future, certainly the regulation of carbon markets is something that we have to get right. And we are certainly going to need you all at CFTC to help us do that, Mr. Chairman.

Under the cap-and-trade legislation, we are venturing to create kind of a whole new commodities market which presents, I think, a number of these challenges that we talk about and issues for Congress. And we thank you for your hard work in this area and the research you have already done in working to try and come up with those solutions.

Just a couple of questions for the Chairman. Obviously, CFTC could play such a large role, as you have mentioned, and has the capability to do that in regulating carbon markets under a cap-and-trade system. What would you say is probably the most important thing that you have learned or that we, all of America, should have learned or could have learned from the EU experience in regulating the carbon market?

Mr. GENSLER. I think that what we have learned from the European experience is these markets are going to be likely sizable, that we have to bring transparency to these markets, that they need to be regulated. They do not yet regulate the over-the-counter derivatives marketplace, and I cannot point to a problem there, but I think enough problems have been in our markets that we should include the carbon markets in what Congress is moving forward in over-the-counter derivatives for sure. But I think transparency and to make sure that we bring it under market regulation, any centralized cash market, any centralized futures market, and also this over-the-counter market.

Senator LINCOLN. Will you continue to, I think, certainly re-emphasize the fact that what we have done in the past here in similar situations has been on a much, much smaller scale when we talk about—you have mentioned the SO₂ and the SOX and the NOX and what we have dealt with there. Do you think what we are dealing with here is too large to deal with, with this type of an approach?

Mr. GENSLER. No, I do not. I think it is just a larger scale. The size of it makes it even more incumbent upon us that we have an oversight function, that the price discovery function is free of manipulation, and that it is transparent; that a national registry, even if it is kept by EPA, is updated on a very regular, real-time basis—not at the end of the month, not at the end of the quarter, but it is really updated on a very regular basis and so forth.

Senator LINCOLN. Well, I have some real concerns about the volatility or the possible volatility in these new markets, carbon markets. And I guess the two questions I would have to you on that would be if you believe that the Waxman-Markey approach is the correct approach to helping prevent carbon markets from wildly fluctuating, what do we see in the possibility of the ramifications of that volatility, that possible volatility, particularly to consumers?

I know Senator Johanns brings up his turkey farmers. I have got a lot of poultry farmers and catfish farmers and others that exactly what happens, cattlemen as well, when the price of that feed goes up, they are out of business. And when they do, then the price of those products, those foods in the grocery stores go up. There is concern all around.

What about that volatility? Do you think the Waxman-Markey approach has enough in it to deal with that volatility? And how do you think that volatility could affect our consumers?

Mr. GENSLER. I think that as Congress tries to address itself to how to lower the emission of greenhouse gases, the trading piece of this, it is most important to make sure there is transparency. Like other markets, there will be some volatility, but the way one addresses that volatility is to make sure that people can hedge their risk for long periods of time, that they are not subject to the

whims of a current weather pattern or some weekly pattern and they can hedge it; they can see that national pricing, they are not subject just to some dark market; and that you have a strong regulator who is going to enforce manipulation standards and aggregate position limits as we seek to do in other markets.

But you are right, and both Senators are right. I mean, there will be some volatility in this marketplace, but I think transparency, anti-manipulation, a national market rather than smaller regional markets, and aggregate position limits are a part of the puzzle here.

Senator LINCOLN. Thank you.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Lincoln.

Again, Chairman Gensler, thank you very much for your testimony and for your leadership at the Commodity Futures Trading Commission. I listened as intently as I could to a lot of the questions. Some of those were kind of policy questions and things like that, but we just need to have you keep in close contact with us on resources that are needed and how we structure the oversight and regulatory regime for this so that it functions well.

I leave you with where I started and, that is, my concerns again about speculation on derivatives and how that might artificially jack up the prices on these allowances and offsets and not in accordance with really what they should be worth. I asked that question at the beginning, and I still have concerns about it, but this would be an ongoing dialog and discussion, I am sure.

Mr. GENSLER. Thank you, Mr. Chairman, members of the Committee, and we are available to be of help at any time.

Chairman HARKIN. I appreciate it very much. Thank you very much, Chairman Gensler.

Mr. GENSLER. Thank you.

Chairman HARKIN. We will call our next panel up: Mr. Timothy Profeta, Director of the Nicholas Institute for Environmental Policy Solutions at Duke University; Mr. Joseph R. Glace, I believe—I hope I pronounced that right—Vice President for Risk Management and Chief Risk Officer, Exelon Corporation; Dr. Dave Miller, Chief Science Officer, AgraGate, and Research & Commodity Services Director for the Iowa Farm Bureau; and Ms. Julie Winkler, Managing Director, Research and Product Development, CME Group, and Member of the Board of Directors of the Green Exchange Venture.

Mr. Glace, did I pronounce your name correctly?

Mr. GLACE. Yes, sir.

Chairman HARKIN. OK, good.

Senator CASEY. Mr. Chairman, Mr. Glace also has Pennsylvania educational roots. Am I correct?

Mr. GLACE. Yes, sir.

Chairman HARKIN. What is this, Pennsylvania Day here? Or what is going on here?

Senator CASEY. We are just going to keep that commercial going. Thank you.

[Laughter.]

Chairman HARKIN. We have Pennsylvania on the next panel, too. Pennsylvania Day here.

Well, welcome to all of you again. You can tell from Mr. Gensler's testimony and our questions that there is a lot of interest in this Committee on how this is not only structured, but how it is regulated. This panel basically will continue our discussion on how we regulate carbon markets in a cap-and-trade system. Our next panel will be from the producer group perspectives, but I understand that a lot of this stuff flows back and forth, and we might get into some producer things also here on the regulatory panel.

As I said in the beginning, your statements will be made part of the record in their entirety. I would ask you to sum up in 6 minutes or less what your main point is so we can get to discussions with you on those points.

I would start first with Mr. Timothy Profeta, Director of the Nicholas Institute for Environmental Policy Solutions, and not a stranger here to the U.S. Senate.

STATEMENT OF TIMOTHY PROFETA, DIRECTOR, NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS, DUKE UNIVERSITY, DURHAM, NORTH CAROLINA

Mr. PROFETA. Thank you, Mr. Chairman. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify today. Right now I wish I went to school in Pennsylvania, but it is an honor to be here.

My testimony today is focused on the issues and concerns regarding the design of the carbon market. Given the financial market failures in recent years, however, it is understandable that a market approach should not be viewed as a foregone conclusion. However, I want to submit at the outset that, in our institute's evaluation of a number of policy options, the market remains the best means to achieve the environmental goals at the lowest cost.

Almost by definition, private actors with a market incentive will find a lower, less costly alternative to reduce greenhouse gas emissions than the Government could determine by fiat. And cost, in the end, is the determining factor. No sector is more aware of this than the agricultural sector. And as one more aside, let me note that the institute this week released a report co-authored by our colleagues at Texas A&M and Oregon State and EPRI to try and put an end to the "he said, she said" debate over agricultural impacts. At bottom, our study found that the net flow of greenhouse gas revenue and indirect commodity market revenues for farmers still outweighed the increased operating costs that we did see from the climate program.

Much of the market's cost-reducing benefits, however, could be weakened if the market does not operate transparently and efficiently. We know all too well that imperfect markets occur. Recent market failures provide a number of lessons, however, that you can apply to the creation of a new carbon market, including the importance of market transparency, vigilant regulators with adequate resources and jurisdiction, and effective risk management.

But before I recommend how these lessons should apply to the carbon market, let me first point out its uniqueness. Carbon will be unlike other commodity markets. It is an especially important point right now as the question of a carbon market is becoming complicated for fear that it will be a proxy for greater commodities

regulation. I would like to point out a few distinguishing aspects of the market.

First, unlike other commodities markets, the entire carbon market is created by the Government to achieve a societal goal. Demand for the product, and the product itself, is created by Government action, and thus the Government has a special duty to ensure that the market operates effectively.

Second, entities covered by the legislation will have no choice but to participate in the market, and it is a market with an ever reducing supply.

Third, the carbon market is likely to be driven heavily by derivatives, underscoring the need to design an appropriate regulatory structure. In particular, climate legislation will likely create a long-term, 38-year obligation for regulated entities, and these entities will need access to financial instruments to hedge their exposure through derivatives—a necessary element to securing investment for new, low-carbon-emitting energy technologies.

I would like to leave you today with four principles for an effective carbon market based on the lessons of the past decade: one, real-time transparency; two, adequate risk management and settlement; three, a vigilant and well-funded regulator; and, four, transparent data and strong quality controls on the allowances traded.

First, transparency. To the extent that instruments are traded on registered exchanges, the exchange member's activity will be "printed" on the exchange providing for the needed transparent information. If OTC transactions are to take place in the carbon market, the legislation will need to ensure that the regulator, market participants, and the general public have sufficient data to oversee and evaluate trading activity.

Finally, Congress will need to balance the public's access to timely market information with the legitimate concern that covered entities may need to protect their confidential business information. In addition to the information made available to the general public, regulators should have access to the full range of market activity in real time in order to prevent and punish market abuses, including fraud and manipulation. The obligation should lie with the market participant to provide the information to the regulator, not the other way around.

Current market participants also need to know that the allowance purchased on the spot, forward, and futures markets, which are held to maturity, will be delivered. In regulated financial markets, counterparty risk is generally managed by clearing the transactions. If the Committee wants to minimize the risk from counterparty failure, as much trading should occur on exchanges, or at least be cleared centrally, as is feasible.

Many will contend that clearing of long-term structural contracts will be difficult, as such transactions are unique and not liquid, and that parties will be required to post the collateral, or margin, necessary to participate in the market. These are non-trivial issues and pose a choice between mitigating systemic risk and creating the additional cost of posting margin.

It is important to note that market participants pay for the risk or risk management somehow, either through the posting of mar-

gin or through the pricing of OTC instruments. It will be your role to evaluate that tradeoff.

In the case that Congress provides exceptions to cleared or exchange-traded transactions, transparency for the counterparties and the regulator is even more important.

Access to market data should be coupled with sufficient resources to process and analyze the information, broad jurisdiction that allows the regulator to oversee any trading that involves allowance-based financial instruments, and appropriate enforcement authority. If Congress will ask the CFTC to take on the oversight of this new market, then more resources will be required to build the team of regulators needed.

Finally, the Government must ensure that the information regarding emissions is transparent, predictable and reliable. It must predictably produce information about the Nation's emissions to allow the market to evaluate the demand. A good example of an effective program has been the U.S. Acid Rain cap-and-trade program.

The Government also must provide the market with adequate assurances that the products traded in the carbon market are what they claim to be. With regard to the emissions allowances, the Government will create, serialize and track the Government-issued right to emit.

With regard to offset credits, however, the Government's role is to provide adequate protocols and procedures to ensure the market that any carbon offset project is real and verified.

The market is a powerful tool, by which environmental objectives may be achieved at historically low costs. Concerns about market abuses have, nonetheless, led some to conclude that now is not the time to create a new market. Let me posit that the exact opposite is true. If you choose to create a market, now is the best time to create a transparent, effective market that prevents excessive speculation and manipulation. The lessons are clear, and the public is attuned to the needs. If it wants to do so, Congress has the tools it needs to create a well-functioning marketplace.

Thank you, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Profeta can be found on page 106 in the appendix.]

Chairman HARKIN. Thank you, Mr. Profeta.

Now we will turn to Joseph Glace, Vice President for Risk Management, Exelon Corporation. Welcome, Mr. Glace.

STATEMENT OF JOSEPH R. GLACE, VICE PRESIDENT FOR RISK MANAGEMENT AND CHIEF RISK OFFICER, EXELON CORPORATION, CHICAGO, ILLINOIS

Mr. GLACE. Good morning and thank you for inviting me to testify this morning. It is truly an honor to be here today.

My name is Joe Glace, Vice President and Chief Risk Officer of Exelon Corporation. Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, ComEd and PECO, serve 5.4 million customers, or about 12 million people—more than any other company in the United States. We have fossil, hydro, nuclear, and renewable generation facilities. Our nuclear fleet is the largest in the Nation and the third largest in

the world. I have worked in the energy field for over 29 years. At Exelon, I am responsible for leading the risk management function, including the identification, assessment, and monitoring of market, credit, and operational risks.

In my testimony today I would like to highlight the following: Exelon's support for comprehensive climate legislation; Exelon's opposition to requiring all trading, derivatives, and hedging activities to be conducted on exchanges; Exelon's support for expanding the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter market; and Exelon's support for the reporting requirements for OTC transactions in the carbon markets.

Exelon was an early and vocal advocate of climate change legislation. Our CEO, John Rowe, first testified in favor of addressing climate change by means of a carbon tax in 1992. We are pleased that the House has passed a comprehensive climate and energy bill and look forward to working with the Committee and the Senate to pass comprehensive, cap-and-trade legislation this year.

Exelon supports a bill with realistic targets and an effective cost containment mechanism, such as a cost collar, and allocating allowances to regulated local utilities with a requirement that the value represented by those allowances be used to provide benefits to customers.

I think it is important to explain briefly Exelon's overall approach to commodities trading. We are not speculators. We use commodities trading primarily to reduce price risk from spot market power prices. Our business model is to lock in, or hedge, the price we are paid for the electricity we generate.

We do this by buying and selling energy products in the markets that are available. For example, we might sell electricity at an agreed-to price for all hours in the summer months of June through September. We also might transact in the over-the-counter market for coal to lock in our fuel cost.

Our customers benefit from this hedging and trading activity. We are in a position to agree to longer-term power sales contracts with both wholesale and retail customers. It is our experience that retail customers, in particular, want stable power prices. Without hedging and trading, that simply would not be possible.

One of the principal concerns many have expressed with adopting a carbon control regime is how it will affect our fragile economy. Simply put, a properly regulated, robust trading program, plus liquid trading markets, will help control the overall cost of the program.

It is important to view the issues before this Committee from the customer's perspective. What steps should the Congress take to regulate carbon trading emissions without imposing undue costs on consumers? Our strongly held view is that any regulatory reform of the commodities markets should ensure that the products which we use to hedge our risks remain available to us and at a cost that is comparable to the costs we face today. We believe it would be a mistake to force most, if not all, derivative hedging activities to exchange-traded platforms.

Today, a substantial component of our derivatives hedging program is in the OTC market without clearing. Transacting on ex-

changes is much more expensive than in the over-the-counter markets because it requires posting of substantial amounts of cash as collateral. This is one reason we do not—in fact, cannot—conduct all of our hedging activity on exchanges. Moving all our hedging to exchanges would require substantially larger cash outlays. This in turn would mean our customers would have to pay substantially more for electricity.

Another drawback of limiting hedging activity to exchanges is that these entities only offer a standardized set of products. Exelon often enters into customized transactions that mitigate the particular risk we are trying to hedge than would one of the exchange-traded standard products. To draw the obvious conclusion, power prices will be higher, meaning consumers will ultimately pay more than they would otherwise, if companies like Exelon are forced to do all of their hedging on exchanges.

I will now turn to the question at hand: what to do about the coming market for carbon emissions allowances. The cost of carbon allowances will be a cost of doing business for generators. It will be just like the cost of natural gas, oil, or coal—an input that is necessary to enable us to make and sell our product. Exelon will need to hedge the price risk associated with that product. Exelon will want to have both exchange-traded and over-the-counter offerings that now exist to manage these risks.

We recognize, however, that there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps. That is why we support the expansion of the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter market. This should allay any concern that any trader could artificially drive prices up.

The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to the OTC markets and perhaps revised and refined to ensure that they provide to the CFTC the tools it needs to prevent manipulation.

For the same reason, Exelon also supports the adoption of new reporting requirements for OTC transactions in the market for carbon allowances. The CFTC has to have access to information about transactions to enable it to fulfill its regulatory oversight and enforcement function. Also, the obligation to report, as such, will be a powerful deterrent to would-be manipulators.

I appreciate the Committee's invitation to testify today. This is a complicated subject area. I hope that I have provided you with a sense of why it is important to ensure that there is effective oversight of the emerging carbon markets while at the same time guarding against over-regulation that would result in higher costs for companies like Exelon and in turn for our customers.

I would be pleased to answer any questions you may have this morning. Thank you.

[The prepared statement of Mr. Glace can be found on page 81 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Glace.

Now we will turn to Mr. Dave Miller, Chief Science Officer for AgraGate, and Iowa Farm Bureau. Welcome, Dr. Miller.

**STATEMENT OF DAVID MILLER, CHIEF SCIENCE OFFICER,
AGRAGATE, AND RESEARCH & COMMODITY SERVICES DI-
RECTOR, IOWA FARM BUREAU FEDERATION, WEST DES
MOINES, IOWA**

Mr. MILLER. Thank you very much for this opportunity to discuss issues regarding market structure and market performance as it pertains to carbon markets. My name is David Miller, and in addition to the activities and services working with the Iowa Farm Bureau and AgraGate, I also farm. On our 400-acre farm in southern Iowa, we converted to continuous no-till in order to qualify to earn carbon credits under CCX rules. I am one of thousands of U.S. farmers who work more than 16 million acres that have been paid for providing environmental services through the CCX enrollment and carbon services. While I have served for over 6 years on various governing committees at CCX, I am speaking today on behalf of AgraGate and the Iowa Farm Bureau.

Occasionally, we have been asked why all of the credit registrations we have done through AgraGate have been on the Chicago Climate Exchange, and the simple answer is that the CCX has the only protocols that are workable for production agriculture and private forestry. Market design and structure matter and are critical to market performance. Some of the items that I would like to discuss today include market transparency, offset protocol standards, and the critical need for fungibility of compliance offsets. And I apologize to the Committee for getting down into the weeds on some of these things, but as a farmer, I know if I do not take care of the weeds, there is no crop.

Market transparency is critical to smooth operation of a carbon market. Transparency means that not only must there be a clear enumeration of what criteria are used to define offsets, but that there must be a mechanism in place so that prices—bids, offers, and sales transactions—are publicly reported and readily available. The only market in the offset market that currently offers that transparency is the Chicago Climate Exchange. Unfortunately, that pricing transparency has been sharply curtailed. Under the provisions of H.R. 2454, there is language that suggests that domestic offsets from current registries may be exchanged or recognized in the Federal regulatory program, but not allowances or international offsets. This has resulted in all offset transactions moving to the bilateral, privately negotiated trades where the buyer can be assured that they will receive offsets rather than the other compliance instrument as might be the case on the electronic platform.

To improve transparency, CCX rules have been updated to require that all these privately negotiated trades be reported. But the bid-ask spread has widened significantly, and the market has fragmented. This has increased the transaction costs associated with carbon marketing and has reduced the net returns to the actual offset providers.

Regulatory uncertainty is now harming the thousands of farmers and companies who have taken the lead in building these rules-based carbon markets, and it is extremely important that we provide a smooth transition for those who are making emissions reductions today in CCX and other verified programs.

With regard to fungibility, the fungibility of compliance offsets is extremely important, where a registered offset credit equals a registered offset credit regardless of the source of the credit. It is a market design characteristic that is essential if the transaction costs of the carbon market are to be minimized.

“Term Credits,” as delineated in H.R. 2454, are not fungible compliance instruments. They only delay compliance obligations. They do not satisfy them. They are an inferior product, and based on the experience of temporary credits under the European trading system, they will have little or no value. It is extremely problematic that H.R. 2454 has relegated all soil sequestration offsets, by design, to the class of term credits. It is neither necessary nor desirable from a market design perspective to address the issue of permanence in this manner.

Design criteria for offset protocols can make or break the viability of agricultural and forestry offsets as real tools in the efforts to reduce atmospheric carbon. To be viable, offsets must be designed for “working lands.” And to be a workable part of the solution, the carbon offset protocols must work within the framework of existing agricultural markets. Length of contract matters. In Iowa, more than 60 percent of the farmland is rented by the operator with the vast majority of that land on 1-year renewable leases. In our experience of working with farmers on carbon offsets, the No. 1 reason why a farmer would not participate in a carbon offset program is the length of contract.

We have looked at the proposed protocols of other registries. Some of these protocols have single-term length commitments anywhere from 20 years to 199 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long.

Generalized quantification methodologies are a very effective and low-cost way to quantify soil sequestration offsets. But do not be fooled by the “illusion of accuracy” that some would say exists when credits are granted based on-site-specific soil sampling. And there is more in my statement about that, but for time, I will leave that to the written.

I would like to address some of the market regulatory framework. As is being demonstrated by the early action programs, carbon can and is becoming a commodity that can and will be traded just like other commodities. The experience of the Chicago Climate Exchange is proving that markets for carbon can and do work. The actual registry and retirement of allowances and offsets should be done on regulated, open, transparent markets with specific standards for price reporting that include date of transaction, vintage, quantity, and price information.

The CFTC should continue in its role as the regulator of derivatives, futures, and options contracts associated with carbon trading, and Farm Bureau opposes the efforts to combine CFTC and the Securities and Exchange Commission and supports regulation of the commodity futures business by CFTC. Derivatives, futures, and options on carbon contracts are not fundamentally different than other derivatives, futures, or other markets. The oversight provided by the CFTC can be adequate for those markets.

In my written testimony, I also talk about some of the capital and margin requirements. Leverage is important, and I think we need to pay attention to those.

I would finish by saying that USDA has a distinct and unique role as part of the administration of offsets, and that is a unique part of also the regulatory structure.

I thank you for the opportunity to be a part of this, and I stand ready for any questions.

[The prepared statement of Mr. Miller can be found on page 90 in the appendix.]

Chairman HARKIN. Dr. Miller, thank you very much for your statement, both here and the written statement.

Now Ms. Julie Winkler, Managing Director, Research and Product Development for the CME Group, and member of the Board of Directors of the Green Exchange Venture, and since everybody is bragging about Pennsylvania, I am told you really came from Waterloo, Iowa. I want to state that for the record.

Ms. WINKLER. That is correct.

Chairman HARKIN. Thank you. Ms. Winkler, please proceed.

STATEMENT OF JULIE WINKLER, MANAGING DIRECTOR, RESEARCH AND PRODUCT DEVELOPMENT, CME GROUP, AND MEMBER, BOARD OF DIRECTORS, GREEN EXCHANGE VENTURE, CHICAGO, ILLINOIS

Ms. WINKLER. Mr. Chairman, members of the Committee, I am Julie Winkler, Managing Director of Research and Product Development of CME Group Inc. and a member of the Board of Directors of the Green Exchange LLC. Thank you for the opportunity to appear before the Committee today and provide our views regarding the regulation of a U.S. carbon market.

The Green Exchange Venture believes that cap-and-trade is the preferred solution for guaranteeing emissions reductions at the lowest possible cost to the economy. In order for the promise of a cap-and-trade program to be met, it must be built on certain design principles.

First, we strongly support providing compliance entities with a choice of utilizing exchange-traded derivatives and OTC instruments to meet their environmental obligations. Also, in order to provide these customers with effective risk management tools and liquidity, the U.S. carbon markets must allow for broad market participation. We further believe that the Commodity Futures Trading Commission is best suited as the regulator of the U.S. carbon marketplace. Last, to ensure the creation of a transparent U.S. carbon market with the necessary liquidity and price discovery they provide, regulatory proposals should not include a transaction tax.

CME Group is one of six founding members of the Green Exchange Venture, which is currently comprised of 13 partner firms from the energy, environment, and financial sectors. CME Group currently provides the electronic trading platform, central counterparty clearing services, and other exchange services. Our partners are currently major participants in the European carbon markets as well as regional environmental markets.

We strongly believe that a cap-and-trade program offers the best opportunity to minimize the cost of mandatory reductions in greenhouse gas emissions. Emissions trading systems are already operating or planned in over 35 countries, and they have proven that cap-and-trade programs can successfully cut emissions with efficiency and cost-effectiveness.

There are several design features that are critical to a well-functioning cap-and-trade system and related derivatives markets. Based on our extensive market development experience, we strongly believe that a cap-and-trade system must include participation beyond compliance entities.

Futures markets perform two essential functions: they create a transparent venue for price discovery, and they permit low-cost hedging of risk. And to be effective, futures markets depend on a broad universe of market participants with both short-and long-term expectations to make markets and provide liquidity.

We also believe that imposed price floors or ceilings should be avoided if a carbon market is to create meaningful price discovery. Price caps reflect factors extraneous to the fundamental factors that drive prices and, thus, are not connected to actual supply and demand.

While it may seem that artificially constraining prices with a ceiling will reduce price volatility or market manipulation, the opposite is likely to result.

We fully understand the motivation to protect American consumers from dramatic increases in the cost of carbon. However, we believe this can be facilitated through strong market oversight and not through price floors and ceilings.

By offering electronic trading of exchange-traded carbon derivatives, coupled with a comprehensive clearing solution, we will enhance price discovery, contribute significantly to liquidity, and reduce risk and uncertainty for market participants. CME Clearing is one of the largest central counterparty clearing services in the world and has provided clearing services for the futures industry for over a century without a single customer default.

Electronic trading and clearing solutions also provide a trustworthy and timely audit trail to effectively identify anyone who engages in misconduct. We believe that because of the CFTC's established expertise and coordination with the global derivatives industry, it is in the best position to provide strong regulatory oversight to the carbon markets.

We applaud the efforts of this Committee and the administration to ensure that a mandatory U.S. cap-and-trade program will enhance transparency, integrity, efficiency, and fairness in the markets. As beneficial as exchanges and clearinghouses will be in a U.S. carbon market, they will not meet all the needs of customers. Although the Green Exchange Venture and other emissions trading platforms would likely be the presumed beneficiaries if all transactions were required to be executed on electronic trading platforms, we do not believe this would be in the best interest of a U.S. cap-and-trade program.

Exchange-traded and OTC derivatives markets are essential to the efficient functioning of a U.S. carbon market. Together, these markets can provide compliance entities with the ability to increase

their certainty in their future cash-flows by protecting against price risk and effectively managing their capital, thereby increasing their ability to meet compliance obligations at the lowest possible cost.

The OTC market is complementary to standardized exchange-traded products by providing products customized to a regulated entity's emissions and their time horizon. While some types of customized transactions must be conducted OTC, the remainder of carbon transactions that we envision will likely lend themselves to exchange-traded products.

While OTC transactions should be present for a cap-and-trade program to be fully successful, the OTC carbon market must provide a greater level of transparency than what is currently present in other OTC markets. As part of its special call reporting, the CFTC already requires extensive reporting of OTC commodity derivative positions. This reporting framework can be leveraged and extended to include new carbon derivatives. Entities such as the Green Exchange Venture will provide capped entities and other market participants with the venue to safely and securely manage their carbon price risks.

Regulated exchanges, clearing solutions, and the CFTC will ensure a high level of transparency to the U.S. carbon markets. This strong regulatory structure combined with added transparency in the OTC market will enable compliance entities to meet their environmental obligations and allow agricultural and forestry offset developers to fully participate in a well-functioning U.S. carbon market.

I appreciate this opportunity to offer these comments to the Committee and will be pleased to respond to any questions.

[The prepared statement of Ms. Winkler can be found on page 121 in the appendix.]

Chairman HARKIN. Thank you very much, Ms. Winkler, for your testimony. Thank you to our entire panel.

Mr. Profeta, are there any reasons why the success of a cap-and-trade approach in reducing sulfur dioxide emissions under the Clean Air Act cannot be replicated here for reducing greenhouse gas emissions? What have we learned from the European market? And why can't we just replicate that here? Is that something that we could do?

Mr. PROFETA. Well, Mr. Chairman, I think the first foremost lesson is yes, both of those experiences have taught us that the market does work. The acid rain trading program somewhat famously came in at about 20 to 30 percent of the cost estimated, what was estimated when the legislation was passed. We found in the EU that the market works as well.

There are distinctions here in terms of this greenhouse gas market that might be created by Congress and those markets that have—I think the universal opinion on this panel would be that there might be greater oversight and need a comprehensive regulatory program at the outset.

The acid rain program is a different scope and scale and not nearly as driven, likely to be driven to the derivatives as this long-term market would. And the EU market as well, the cost was somewhat mitigated by some of the distinctive features in the EU market and has actually started to gravitate toward exchanges.

Now about 50 percent are on an exchange, and, of course, the EU market also, being short term, does not have the long-term requirement of the emitters that this would have.

So both those teach us a lesson that the markets can work and also there can be distinguishes not in need of regulatory oversight as this one.

Chairman HARKIN. I also want to note that in your written testimony, you mentioned as an aside the study that was co-authored by several leading agricultural economists. You said it found that “the net flow of greenhouse gas revenue and indirect commodity market revenues for farmers far outweigh the increased operating costs.” It says “benefits to crop and livestock producers far outweigh these economic losses”—to consumers and agricultural processors—“signaling gains to the sector as a whole. If done the right way, agriculture can be made a winner in climate legislation.”

I assume, though, that there are some sectors within agriculture that will do better than others. Is that right?

Mr. PROFETA. Absolutely true. There will be ebbs and flows in the system, and some sectors and some farmers will do better than others. I think in general we have found there were higher input costs but higher output costs as well, a modest consumer response, increased bioenergy supply, and offset income opportunities. And the key feature, the main benefit to the farmers that really come through in these modeling runs come through indirect commodity market shifts that drive up crop prices and revenues. So that is not seen in some of the other studies, and I should note that in doing that we reached out to our colleagues at places like Texas A&M and Oregon State to try and bring together a team that could get after the “he said, she said” that has been happening in terms of the agricultural economics of climate.

Chairman HARKIN. Mr. Glace, do you believe a price collar a floor and ceiling would bring about desired certainty in terms of controlling risks and volatility? How do you feel generally about a price collar?

Mr. GLACE. Exelon advocates the use of a price collar. The main reason is to protect customers from higher prices in the early transition period for this program, if you will. We think that it is very important to protect customers from being impacted by higher prices, and we think that is the primary use of the collar. In any risk management situation, if you are afraid of volatility and uncertainty, it is nice to have options. Collars and floors help band in some of the risk, and these are the tools in the bag that we all use routinely to manage risks.

Chairman HARKIN. I want to turn now to Dr. Miller and Ms. Winkler. I have only got a minute left here, but back to the issue of derivatives and swaps and the over-the-counter market, Ms. Winkler is basically praising and is in favor of that. Dr. Miller, you raised some questions about it.

As I understand, Ms. Winkler, you are saying that we need this to get financing for offset projects. Well, that may be one way, but aren't there other ways such as forward contracting, traditional bank lending, or guaranteed USDA loans that could also ensure offset projects get financed rather than just through a derivatives?

I am concerned about this view that we must have customization, especially when compliance obligations are measured in standard government-issued allowances due each April 1st. Given that do we really need customization? I am still searching for that answer. Ms. Winkler?

Ms. WINKLER. Yes, Chairman, I think the best example would be my fellow panelist Joe Glace talking about the needs for him to have the flexibility to have both customized transactions in the over-the-counter market in addition to the standardized exchange-traded products that he uses. So while financing is certainly one reason why people would use over-the-counter instruments, it is not the only reason. You know, some of the other things is that it can help an emitter specify the actual emissions that they are offsetting against and hedging against, and also being able to customize it to the time horizon that they are most concerned about.

Also, as Joe pointed out, you know, for some entities it becomes more difficult to be able to post that collateral with the exchange in terms of the margin requirements, and with the role of an exchange and a clearinghouse, we are providing mark-to-market and settlement values on a daily basis, which could at times, with price movements, require substantial dollars to be moved in and out of the clearinghouse.

Chairman HARKIN. Dr. Miller, do you have any observations? My time is—

Mr. MILLER. Yes, I think one of the great issues is transparency of the over-the-counter market, and you can gather and get additional transparency with reporting. We do reporting of the cash grain markets. We do not report every individual transaction, and we do not report who was at the transactions, but we do report the prices and we do report where those things were happening. And that gives sufficient transparency to that system that it functions well, and that is partly what is missing in the current over-the-counter markets.

Chairman HARKIN. Got it. Thank you.

Senator Chambliss?

Senator CHAMBLISS. So, Dr. Miller, if we went to a system where there was complete transparency and the reporting of those contracts that were traded over the counter, would that address the concerns that you have about OTC?

Mr. MILLER. To a large degree, I think it would, particularly as it would apply to the compliance instrument itself. The actual offsets or allowances are going to be registered products that are standard products because they are a compliance instrument. And right now in the voluntary market, the only exchange that is doing broad-based price reporting is Chicago. The other exchanges, I went out and looked, and I cannot find reported prices for the Climate Action Registry. I cannot find reported prices. I can for the futures markets that are regulated, but for the spot markets on a number of these other projects and CDM projects, there is no price reporting. There is no transparency.

The associated issue that is connected with that, though, is leverage, and one of the problems that was part of the debacle, if we would say, that occurred in the financial markets with regard to credit default swaps, et cetera, was not only a transparency issue

but a leverage issue. And, yes, there is cost to doing margining and things on exchanges, but the exchanges did not have any defaults, the exchanges did not have those problems because there were limits to the amount of leverage that could be put to those type of derivatives.

Senator CHAMBLISS. Well, Ms. Winkler, if we develop a system that requires transparency of all trades, whether they are standardized trades or whether they are more tailored transactions, which I assume we could devise some system to do that, would that interrupt the market in any way, in your opinion?

Ms. WINKLER. Senator, we are very much in support of full transparency of the marketplace, and, you know, our goal as operating an exchange and a clearinghouse is being able to serve as the price discovery vehicle for what carbon is in the U.S. And I believe through our existing infrastructure and also the audit trail that our electronic trading system and our clearing system can provide, in the close coordination we have with the CFTC, we are going to be able to easily accommodate that additional transparency that is going to be needed.

Senator CHAMBLISS. Mr. Glace, would your ability to enter into financially settled swaps for electricity such as the example outlined in your testimony be hindered or become more expensive under the recent proposal put forward by the administration for regulating over-the-counter derivatives?

Mr. GLACE. Yes, sir. We believe that, again, a lot of the forcing to organize the exchanges would seriously reduce the amount of hedging that would be able to be done in the marketplace because of the fact of all the initial cash that has to be put up to support the transactions.

Senator CHAMBLISS. And who is going to pay for that ultimately?

Mr. GLACE. Ultimately, consumers pay for this additional—any additional cost that enters the system ultimately finds its way into the price to the consumer.

Senator CHAMBLISS. Yes. Well, in talking about the transparency issue, which I think is going to be the focus of the debate when we get to this financial system overhaul issue, I assume you have no issue with transparency.

Mr. GLACE. No, sir.

Senator CHAMBLISS. You are not trying to hide anything or do any secret deal out there. So is there a way, in your mind, that we could develop a system that would provide full transparency and allow you to operate in the market with tailored transactions like you sometimes do today?

Mr. GLACE. Absolutely. Exelon supports expanding the CFTC's jurisdiction and expanding the CFTC's ability to gather reporting and transactional information to assess positions. And we believe in rigorous oversight in the markets and full transparency.

Senator CHAMBLISS. Mr. Profeta, let me ask you to comment on that same question. You encourage, obviously, the clearing of all transactions "as is feasible," I think is the way you put it in your testimony. I think that has been stated an awful lot and with different wording by different experts in this field. But is there a way to take tailored transactions, in your opinion, and whether you call

them standardized or not, effect total transparency in the marketplace?

Mr. PROFETA. I think the most important thing is to make it transparent to the regulator, and I think it is possible to do that in much the way my co-panelists have described here. The best way to control for the risk is to build it into the system so you do not get to the point where to regulate it is to see it. But there are distinct, long-term structured deals that it appears cannot be standardized and put—cleared. And if it is open and apparent to the regulator, I think we can control for a lot of the risk that way.

Senator CHAMBLISS. What do you think would be the biggest hurdle in having a tailored product transparent to the regulator? Or is there a hurdle out there?

Mr. PROFETA. I think it is just a matter of establishing the correct authority for the regulator to receive that information. As I suggested in my testimony, it may be appropriate to put the obligation on the transacting parties to give the information to the regulator rather than putting the obligation on the regulator to make sure that the data gets to the CFTC.

Senator CHAMBLISS. Mr. Chairman, I know I am over my time, but let me follow up. Mr. Glace, is there a problem from your standpoint as a participant in these contracts in the marketplace in providing the regulator with full disclosure of what the transaction that you have entered into from the hedge standpoint is all about?

Mr. GLACE. No, sir. Full disclosure is not a problem.

Senator CHAMBLISS. OK. Thank you.

Chairman HARKIN. Thank you, Senator Chambliss.

Let us see now. Senator Johanns?

Senator JOHANNNS. Mr. Profeta, let me get started with you. I think in response to some questions, you have acknowledged that for farmers there is going to be higher input costs, and I think virtually every study shows that. Is that something we agree upon, input costs will go up?

Mr. PROFETA. Yes, input costs will go up. Fertilizer costs may be controlled by provisions to help that industry, but input costs will go up, yes.

Senator JOHANNNS. And I think the fertilizer business would debate you on that one. They seem to believe their costs are going to go up also.

Mr. PROFETA. I have said the word “may” cautiously because I have no idea what the Senate’s policy will be on that and how it will be affecting the industry. But there are efforts at least to try and hold that sector of the industry harmless.

Senator JOHANNNS. Now, as I understand the Texas A&M study—and, again, by inference from your testimony, it appears that you are reaching much the same conclusion—it is not the credits or allowances or whatever that is really going to help the farmer out to deal with those input costs. It is your belief that they will get a higher price for their products, right?

Mr. PROFETA. Yes. This is the study that we released. I am happy to bring the authors who are intimately familiar with it to meet with you, Senator. But, yes, their findings were that the key benefit to the farmers comes from the indirect commodity market

shifts that drive up the crop prices and their revenues. They do have some benefits from the offsets, from tillage practices, manure management, et cetera, but that is not the driver. The driver is the crop price.

Senator JOHANNNS. Now, if you are on the buying end of that, though, if you are in the dairy industry—which is absolutely going broke at the moment, if you are in the pork industry and one pork producer said to me recently, he said, “Mike, we are 30 days from being bankrupt.” If you are in the cattle industry that has not made money for 2 years, this is pretty much a disaster for them, isn’t it?

Mr. PROFETA. I would like to go through the numbers with you. I do not think that the input cost projections that came out of the study are in the realm of disaster, particularly compared to the fluctuations we have had in those input costs in the past year. They far exceed what would be projected out of this legislation.

Senator JOHANNNS. Well, if you are the one going broke—and, believe me, dairy is not making any money at the moment, quite the opposite. Pork is really getting hammered. Beef has not been good for a couple of years. Call it what you want. This is not a good situation.

Mr. PROFETA. Senator, I would agree, and let me be clear. The intent of the study was try and get after, you know, the assumptions and lay them there and let you as a Senator to make a judgment as to—I am from the State of North Carolina. I work with the pork industry a lot. I know how they are suffering. And I am certainly not advocating for any legislation that would cause the kind of pain that you feel.

I think there are ways to balance these societal objectives, not hurting the industry and also addressing climate change, and what we are trying to do is give you the data that helps you get to that place.

Senator JOHANNNS. Now, let me, if I might, kind of pivot off of your comments to Mr. Glace. Mr. Glace, you are, as I have described, a big guy—not in stature. In business is what I am referring to. How big are you? What would your revenues be in a year?

Mr. GLACE. Approximately \$15 billion.

Senator JOHANNNS. \$15 billion. Now, if we do something up here that impacts your bottom line, you are just going to pass it on to the consumer, right? You are not going to go broke.

Mr. GLACE. Exelon believes that all costs to manufacture and inputs to make electricity ultimately get into the power price, and that does, in fact, get to the consumer.

Senator JOHANNNS. Yes. And if you are the irrigator and you are buying electricity, they are going to pay more, right?

Mr. GLACE. Yes, sir.

Senator JOHANNNS. One of the concerns I had with the study, the Texas A&M study, is the two farms they looked at in Nebraska were dryland, and about 60 percent of our row crops are actually irrigated. So those irrigators are going to pay more for electricity if, in fact, the Government raises the cost of doing business.

Mr. GLACE. We believe that power prices will increase, yes.

Senator JOHANNNS. Now, you can hedge your risk just simply because you are going to notify somebody in an electric bill that they

are paying more. But where the farmer does not set the price, how do they possibly compete with you? I mean, you are such a big enterprise. You can control your prices. The poor farmer out there just is going to get what they get, and if it causes them to go broke, they will go broke, won't they?

Mr. GLACE. Again, I cannot speak for the farmers' economics very specifically, but we do believe that all—Exelon believes in markets, and markets set prices. And whatever the buildup of the ultimate market inputs are that determine the market price, the market clears and the market sets a price. And Exelon believes that markets produce the least efficient—the most efficient, excuse me, possible outcome for the consumer, and that a market-based solution is always going to be the least cost or most effective solution.

Senator JOHANNIS. See, here is the problem with that in agriculture. The fat cattle guy cannot go to Tyson's and say, "Boy, you know, I just got a higher electric bill, and I got this and I got that. Instead of selling these fat cattle for \$100, I need \$110." Because you know what? Tyson's is going to go, "So what?" I mean, it is the reality of the marketplace for farmers. Do you agree with me there?

Mr. GLACE. I do not pretend to know the farmer realities and the farmer marketplaces, but I do know that if a market sets a price for clearing that the farmer will get a bill that is commensurate with that market price.

Senator JOHANNIS. They cannot pass it along.

Mr. GLACE. I will take your word for it.

Senator JOHANNIS. Yes. Well, that is the way it works.

Mr. GLACE. Absolutely.

Senator JOHANNIS. Thank you.

Mr. GLACE. Thank you, sir.

Chairman HARKIN. Thank you very much, Senator.

Now Senator Gillibrand.

Senator GILLIBRAND. Thank you, Mr. Chairman. I want to go over some of the issues that Ms. Winkler raised and some of the questions that you asked, Mr. Chairman.

One of the issues was about why do we need a customized market, and there were a couple of areas that I wanted you to perhaps provide—anyone on the panel who has information and wants to provide more detail, that would be helpful.

On the question of whether it will provide offset projects financed under the bill, will be able to provide the financing, one of the reasons is that financing for projects is often contingent on a firm being able to predict their future carbon risk through a derivative contract, for example, and if you just have exchange-traded, you have no more than 5-year-out contract.

So could you please elaborate more on that financing perspective, because the Chairman brought up, well, why can't you just get a loan? What is the difference with that access to capital, then the liquidity that the derivatives market would provide, if any, to further answer that question?

Ms. WINKLER. Thank you, Senator. One of the main differences is just because of the customized nature of that instrument and the financing needs for those particular projects that need to be developed. It is in their best interest to be able to deal with a

counterparty that is able to, you know, lend to them and also that they are able to contribute toward the financing of that the physical assets that they have. And in the cases of many of these project developers, these projects take anywhere from 7 to 10 years and, especially in terms of the offset projects, need to be verified and approved along the way. So there is a substantial amount of risk that is outstanding. A typical lender is going to find that pretty difficult to be able to stand behind that at a reasonable rate.

Senator GILLIBRAND. So you are saying that the lending market may not be readily available because of the outstanding risk, and so that you really need a derivative to hedge that risk specifically for the amount of time that that project may well take to come to fruition.

Ms. WINKLER. That is correct.

Senator GILLIBRAND. Now, is that your experience, Mr. Glace?

Mr. GLACE. Yes.

Senator GILLIBRAND. OK. Second, you said in your testimony, Ms. Winkler, that if you were going to have—if you were not going to have a customized market, it would leave out certain players who need access to these markets because of the capital requirements. But one of the things we talked about earlier that the Ranking Member brought up was that we would actually want capital requirements. And, in fact, not only do we want complete transparency for what the trade is going to be, but that we actually might even have higher capital requirements because of the increased risk. So that does not address your—that would undermine your argument that certain players would, therefore, be excluded from the market.

Ms. WINKLER. I think the way to describe it is that an exchange-traded market, we believe, relies on broad market participation, and that is kind of central to being able to have the market determine what that carbon price is going to be.

There are many differences in terms of the over-the-counter market and the level of sophistication of the people that interact in that market, and typically they are eligible contract market participants. And so I think there are pretty significant differences just between who we would anticipate dealing in that customized market versus what we would expect in the exchange-traded market. And it is certainly our hope and our intention that both markets have to have increased transparency over what they have today.

Senator GILLIBRAND. And capital requirements. I want to get to your argument that you thought the reason why we needed to have an OTC market was because there would be no capital requirements. And what I think the Ranking Member was getting at is if we create this over-the-counter market and allow for it, it is going to need increased transparency and significant capital requirements, which would undermine your argument.

Ms. WINKLER. The capital requirements is certainly something that is under review by the administration as part of their larger over-the-counter and financial regulatory reform. So we would view that anything that would need to be done in carbon over-the-counter ets would be in line with those broader goals of the administration.

Senator GILLIBRAND. And then the third issue that addresses this is the question of foreign carbon allowances to be purchased and used for domestic appliance. It is allowed in the Waxman-Markey bill right now. However, the issue of mandated standardization and exchange trading is impacted because 75 percent of the European market right now is over the counter. So how do you see that impacting the harmonization efforts that we are trying to make and participation—if the EU, for example, has a 75-percent over-the-counter market and the U.S. has none, how will that affect us in terms of competitiveness or access to capital or liquidity or volatility or any of the issues that you brought up?

Ms. WINKLER. I think the biggest concern, Senator, is that if there is not an over-the-counter market that is allowed in the U.S., we believe that that activity is going to take place—

Senator GILLIBRAND. Go overseas.

Ms. WINKLER [continuing]. And it is going to go overseas to less transparent environments and areas where our regulators do not have as direct authority as they do here in the United States. While we certainly still see, you know, some transactions taking place in the over-the-counter market, we have been seeing a trend in the EU ETS toward clearing. And that has been a positive trend, and it kind of speaks to how over-the-counter markets develop over time, and they do become more standardized, they do become more liquid. And now kind of the predominant number of the instruments are being cleared, and we would view that being as much of the same development that we will see here in the U.S. But our primary concern is that if we do not allow over-the-counter transactions, people are going to need those customized tools, and they are going to lend themselves to less transparent environments that we do not have the authority to regulate properly.

Senator GILLIBRAND. Thank you.

Chairman HARKIN. Thanks, Senator Gillibrand.

Senator Lugar?

Senator LUGAR. Thank you, Mr. Chairman.

In our last comprehensive hearing on this subject, the testimony of Secretary Vilsack was that all farms would benefit from a cap-and-trade situation similar to the House bill. Senator Chambliss, in releasing the Texas A&M study, which has been cited several times in the hearing, indicated that 71 farms would not prosper, 27 would, and so that is quite a disparity. And the reasons were varied, but the farms that came out best were farms such as my farm in Indiana that produces corn and soybeans.

I take the privilege of these personal references because I want to ask you, Dr. Miller, about a situation on my farm or maybe at yours. We have about a third of our acreage in corn, a third in soybeans, and a third in trees. About 22 years ago, my son and I started planting black walnuts in rows, some other trees subsequently, and in due course, the Chicago Climate Exchange approached us and said, "Would you like to be a partner in this exchange?" They wanted some farm in Indiana at least to have that situation going, but they could measure only most recently planted trees because the idea was that if you have trees already on the farm, why, those were already there. The incentive was to plant more.

So, as a result, they measured some of our trees, and I have been accumulating credits. I go to the website of CCX and find that I have no several thousand tons of carbon sequestered in those trees on the farm.

My problem is that the price of that carbon per ton has been plunging. It was as high one time as \$7 a ton. It is now 25 cents a ton as you go to the website today.

Now, there is something wrong with the market there, as we are all busy patting about climate change, and yet the markets are not reflecting that much is going to happen there.

Now, CFTC, in a very bold move, has taken CCX apparently under its wing and at least is hoping that this may be established as a market of sorts.

I go through all this detail to say that it is not at all clear, even if you were on a farm in which you wanted to put pastureland into trees or, as the Texas A&M study points out, most of the gain for the corn farmers comes from the fact that fewer acres apparently are planted. Therefore, supply and demand raises the price of corn, and that has all kinds of implications in terms of the American food system, quite apart from the worldwide food system in which our whole emphasis is on more acreage and more production with the population of the world growing.

These are all contradictory problems but relevant, I think, to the ordinary farmer who might contemplate. How do you, in fact, stay alive? Do you plant trees? Is there going to be a similar market for no-till planting? We have had celebrations at the Farmers Union, people here in our Committee.

I ask all of this simply to raise a question that maybe you can help answer. How established is it that there is going to be any market for my trees or any trees I should plant? How about the trees that are already there if I promise not to harvest them? You say a contract period of 5 years or 10 years. Do I get credit for that? Or is that in the past? Give me some inclination, if you can, from this practical example.

Mr. MILLER. The market is in its infancy, and in its infancy it will have more variation and gyration than it will in a mature market. But regulations matter, and one of the challenges that the current Chicago market has is that part of its tradable compliance instruments were deemed basically worthless by the future regulations. Therefore, that piece of the market is trending toward zero.

The offsets are not trading at zero, but they have had to move to the over-the-counter market to find value. And so when we sell offsets such as from forestry or soils right now, we are trading at 4 times, 5 times, 6 times what that listed exchange price is that is trading allowances that 2454 did not recognize.

So it is the same problem Europe had when they did not allow banking forward of a market that was long offsets in the current term or long allowances in the current term. They went to zero, and that is what markets do when you have an excess supply of something that has no carry-forward.

Relative to the ability for farmers to participate, we are at, again, the infancy of what all these solutions can be from the agricultural and forestry sectors in our markets. The CCX, which has the only broad-based set of workable protocols, is an incomplete

set. There is a real role for USDA to help set and develop additional protocols. Nitrous oxide management is one that possibly almost all farmers could participate in. But we have no standard protocol for that yet. It is a more expensive protocol to probably do. It is more difficult. It has got some scientific challenges.

At CCX, we took the ones that had the best science around them at the time we did them and started with those, and we have added protocols.

In the Texas A&M study, their ranches did not have any offset income in the Texas A&M study, and I am quite familiar with that. Partly, when they did their panels, the CCX rangeland offset requires management of the stocking rates, and those particular ranches in those representative panels could not economically do what is required of the CCX offsets in order to get offset credits. We have ranches that are complying with that—us, Farmers Union, various different aggregators—but it is not something that every ranch is going to be able to do and remain economically viable. And I think that is one of the things we have to be aware of. While it might be technically feasible for the individual resources that are available, it may not be economically viable to do the things that are required in order to earn offsets.

Senator LUGAR. I ran over my time, Mr. Chairman. I would just underline the importance for our Committee, if we are to adopt a cap-and-trade situation, to go well beyond the House bill and to get into the weeds, so to speak, of this because, otherwise, this is going to be a fiction that somehow there are allowances here, or credits or even a market, without somebody going into the details Dr. Miller has just illustrated in brief. And I think this is critical, or we are going to leave farmers absolutely without defense in this situation, I think zapped all across the board.

Chairman HARKIN. Senator Lugar raises a good point. I thought about this at that previous panel that, you know, you have a stand of trees, we had a forest, a private forest. Now, because he is not adding anything additional, therefore, he gets no offsets. But if he cut down his trees and planted new ones, well, then he would be OK. This is that same old thing that we have been through so many years on this Committee on conservation and other things. If you tear out what you have got and plant something else, well, then you will get the benefits. But if you just keep your conserving practices or what you have done to your land, then you do not get anything, and that just does not make sense to people. It does not make sense to me either. So we have got to address that also on this.

Well, thank you all very much, and we will call our next panel. Thank you very much.

Our next panel, our producer group perspectives, we have Mr. Andy Beckstoffer, and he will be introduced by our colleague. Come over here, Mike. Then Mr. Frank Rehmann, Chairman of USA Rice Producers' Group from California; Mr. Luke Brubaker from Brubaker Farms in—I had a wrong address here on it—Pennsylvania. Mount Joy, Pennsylvania. Mr. Fred Yoder, Past President of the National Corn Growers Association from Ohio. We will ask you all to take your seats there.

We are graced with the presence of a long-time friend of mine, our colleague from the House side, Representative Mike Thompson, and I am going to turn to him for the purpose of introduction because I know he has to get back to the House. But in my way of introducing the introducer, I will just say that Congressman Thompson was first elected to represent California's 1st District in 1998. It includes all of Napa, Lake, Mendocino, Humboldt, and Del Norte counties. I do not know what else you have added. Sonoma County, too?

Mr. THOMPSON. Part of Sonoma.

Chairman HARKIN. Part of Sonoma County, and Yolo, also. Prior to serving in Congress, Representative Thompson represented California's 2nd District in the California State Senate, where he chaired the Budget Committee. So, again, not a stranger to us at all, and a great friend and colleague from the House side. I will turn to Congressman Mike Thompson for purposes of introduction.

**STATEMENT OF HON. MIKE THOMPSON, U.S.
REPRESENTATIVE FROM THE STATE OF CALIFORNIA**

Mr. THOMPSON. Well, Mr. Chairman, thank you very much, Mr. Vice Chairman, thank you also for allowing me to do this. I have got a couple friends testifying today, but I have been asked and am honored to introduce one that I represent at home, and that is my good friend Andy Beckstoffer.

Andy is the founder and the Chairman and the owner of Beckstoffer Vineyards, which farms over 3,000 acres of vineyard in Napa, Mendocino, and Lake counties of California. He is the largest non-winery grape grower in Napa Valley and along California's north coast. He is also the largest seller of premium winegrapes in Napa and on the north coast area, and he provides grapes to over 80 premium wineries.

Since 1970, Beckstoffer Vineyards has been a leader in developing and implementing new vineyard technologies in the California premium north coast area, and Andy has been recognized around the world for these efforts. And I hope he gets a chance to talk about this, but he is doing some great stuff now, a whole bunch of new organic plantings in Mendocino County and Lake County, and something that he might not think is exciting, and maybe you will not either, but being a vineyard owner myself, we have to rip our land before we plant vineyards, and Andy now in his new plantings, he is only ripping the area specific as to where the grapes will be planted, not disturbing the rest of the ground, which I think is pretty cutting edge.

In 1975, he was a founding director of the Napa Valley Grape Growers Association. In 1976, he became a member of the Napa County Planting Commission and in 1983 a director of the Winegrape Growers of California. He is also a member of the World Presidents Organization, a director of the Wine Market Council, the California Association of Winegrape Growers, and the Land Trust of Napa County. And he is an accomplished conservationist. As a farmer and businessman, he understands that investing in the conservation of our land is an investment in our future. His leadership in helping build national support for increased tax in-

centives to put property into conservation easements will be felt for generations to come.

I carried that bill in the House. It has tremendous support over here in the Senate, and he was really the catalyst for that, helped put it together, and he not only talks the talk, but he walks the walk. After that bill was passed, he was the first landowner across the country to put his land into a conservation easement, and it is really significant because it is a historic vineyard in the Napa Valley. And if I told you the property values of a vineyard like that, most people in agriculture would not believe that they would draw that kind of money.

So he has been on the cutting edge. He has worked to restore the Napa River throughout the Napa Valley, and he is a lifetime expert in specialty crop farming. And as everybody in this room knows, specialty crops represent about 50 percent of the entire plant crop economy, and they contribute mightily to our Nation's nutrition.

He has a hands-on knowledge of how not only climate change is affecting winegrapes, but also the benefits that specialty crops provide in helping our country meet the challenges of climate change.

I want to thank you all for allowing me to do this, and I want to thank you in advance for listening to his comments. And I am just proud to be the one to have brought Andy to the Senate.

Thank you.

Chairman HARKIN. Thank you very much, Mike. You are welcome to stay if you would like. I know you have probably got—

Mr. THOMPSON. We are working on this thing called "health care reform" over there.

[Laughter.]

Chairman HARKIN. I have heard of it. I have heard of it. All right. Well, thank you very much, Mike.

Mr. THOMPSON. Thank you.

Chairman HARKIN. I really appreciate it very, very much.

Then we will start with you, Mr. Beckstoffer, and we will work from right to left in this regard. Mike was mentioning something about ripping grapes and stuff. I turned to Saxby, I said, "Is that like minimum tillage that we know about?" It sounds a little bit like that.

Also, I want you to know something else. In 2000, in my State of Iowa, we had a total of 100 acres of grapes in Iowa. We now have over 1,000. So look out, here we come.

[Laughter.]

Senator CHAMBLISS. Mr. Chairman, let me just say, too, that Mike happens to be the Chairman of the Wine Caucus over on the House side, and as a former Member of the House and a consumer, Mr. Beckstoffer, we appreciate you sending a little bit up here every now and then of your fermented product that we can make sure we test every now and then.

Chairman HARKIN. Mr. Beckstoffer, welcome, and please proceed. Again, I am going to ask you to summarize. As you probably have heard, all your statements will be made part of the record in their entirety. If you could sum it up in 6 minutes, please.

**STATEMENT OF W. ANDY BECKSTOFFER, CHAIRMAN AND
CHIEF EXECUTIVE OFFICER, BECKSTOFFER VINEYARDS,
RUTHERFORD, CALIFORNIA**

Mr. BECKSTOFFER. Thank you very much. I live in St. Helena, which is a small agricultural town in the Napa Valley of California, and my family grows winegrapes, as you said, and that in your terms is a specialty crop.

We are small farmers, but grapes are a big business. There are over 24,000 grape growers in the Nation, and the full economic impact of wine and grape products is estimated at over \$162 billion. Grapes are grown in over 40 States today, and grapes are a significant part of the specialty crop segment of the U.S. agricultural economy. Specialty crops, as Mike says, represent approximately 50 percent of the farm gate value of total plant agricultural production.

We in the winegrape and wine business are very proud of the fact that most medical people believe that wine is good for your heart. I truly believe and hope that that is true.

Chairman HARKIN. I believe.

Mr. BECKSTOFFER. But, for sure, grapes and peaches and pears and carrots and lettuce and tomatoes and all fruits and vegetables are specialty crops that provide essential nutrition to the American people. That is where their real importance is.

Where I live in the Napa Valley, it is a very well known premium winegrape-growing region. What is not so well known is that while some 9 percent of Napa County's land mass is devoted to vineyards, over 10 percent of the county's land is protected by some sort of open space or agricultural conservation arrangement. Conservation and environmental sensitivity are hallmarks of our lives in the wine country. The increased tax incentives on conservation easements which were legislated in 2006 have made a major contribution to our ability to conserve these agricultural lands. In our small valley, over 1,650 acres have been put under conservation easements since 1960, and over 300 of that has been our lands.

Senator Baucus here in the Senate and Congressman Thompson in the House are now sponsoring legislation to make those incentives permanent. These incentives are crucial to land conservation. They are crucial to keeping small farmers on the farm and ultimately crucial for positive climate change.

In considering my testimony, in the limited time I want to emphasize three major concerns.

First, specialty crop growers are generally relatively small farmers. Our family is the largest vineyard owner in the Napa Valley and the north coast. But on any statistic involving all farms, we are very small farmers. This is the case with most specialty crop farmers. We are scattered politically and geographically and do not have the organization or capacity to compete with the large program crops for adequate consideration in major legislation, such as that involving climate change. Without your special indulgence and careful consideration, much of the Nation's nutrition engine will suffer.

Second, it has been widely reported that many car dealers have opted out of the Cash for Clunkers program because of the heavy documentation requirement on their limited staffs. We have simi-

larly limited staffs. I would hope that the reporting requirements of any climate change program would be held to the minimum.

Third, the USDA's Economic Research Service reports that between the years 1997 and 2002 over 8 million acres of American farmland have been lost to agriculture due in good part to urbanization and economic pressures. In California, our population is estimated to double in the next 25 years.

In the Napa Valley, some 60 miles from San Francisco, there is tremendous urban pressure. It is my view that winegrape vineyards here are the long-term highest and best economic use of the land. And for this reason, we have been able to preserve the vineyards with that urban pressure. This is true in varying degrees in all agricultural lands near urban areas. These lands in many cases are relatively small specialty crop lands. It is widely anticipated that Federal and State carbon reduction programs will increase costs for energy, fertilizer, pest management tools, and other inputs such as transportation. If winegrape growers and agriculture are not excluded from any carbon emissions cap while being able to receive credits for offsets provided, these unaddressed increased costs will result in the loss of an additional increment of agricultural lands.

Further, it is my understanding that agriculture, through plant and soil sequestration, has been identified as a priority area for cap-and-trade offsets. If the profitability of agriculture is further reduced through increased costs and competition from foreign wines made with cheap labor with Government supports, that will serve to limit the availability and expansion of agriculture as an important component of any cap-and-trade program.

The winegrape quality and standards in the Napa Valley are in no immediate danger or short-term danger from climate control activity. There are some things that are changing, however. For example, we are experiencing more heat spikes. Generally speaking, heat and sunlight bring beneficial effects to grape ripening and maturity. We prepare our trellises and canopy management to accept and accentuate this. When heat spikes occur, they damage the grapes and thus we must prepare our trellises to avoid sunlight and heat—in direct contradiction to our major objective of heat and sunlight accumulation.

The nights are getting warmer. The secret of producing great winegrapes involves achieving a chemical balance between sugar, acid, and pH. Sugar is accumulated during the day, acid in the cool nighttime temperatures, and pH at both times. Climate change is increasing our nighttime temperatures, and at this time we have no way of knowing the effect on grape balance and quality. We greatly need research to show these effects. I understand that most of the carbon sequestration research has been done on annual crops. Our vines with a 20- to 40-year life span have a significantly different carbon footprint, and their relationship to annual crops should be analyzed.

Another area where climate change is beginning to affect us is pest infestation. The disruption in the ecosystem is producing new pests and mutations and vine diseases that we just do not understand. This could have a major effect on our ability to limit pesticides.

For reasons of economics, fruit quality, and soil and water conservation, we have over the past many years drastically reduced our tractor usage in the vineyards. We limit irrigation practices for reasons of fruit quality, and when we do irrigate, we use effective drip irrigation. We make extensive use of cover crops to host beneficial insects and limit pesticides as well as reduce tillage to limit soil moisture. We—

Chairman HARKIN. Mr. Beckstoffer, could you summarize?

Mr. BECKSTOFFER. OK. We in the grape business have been practicing for a long time, and we just hope that these early practices will be recognized in any potential carbon market or offset program.

Thank you very much.

[The prepared statement of Mr. Beckstoffer can be found on page 65 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Beckstoffer. I am sorry. We are just running out of time.

Next, Mr. Frank Rehermann, Chairman of USA Rice Producers' Group, also from California. Welcome, Mr. Rehermann. Please proceed.

STATEMENT OF FRANK REHERMANN, CHAIRMAN, USA RICE PRODUCERS' GROUP, LIVE OAK, CALIFORNIA

Mr. REHERMANN. Good afternoon, Chairman Harkin, Ranking Member Chambliss, and members of the Committee. My name is Frank Rehermann, and I am a rice producer from Live Oak, California. Since 1972, my wife and I have produced rice in a family partnership which now includes our two sons. I currently serve as Chair of the USA Rice Producers' Group, one of four organizations which comprise the USA Rice Federation. And, incidentally, Chairman Harkin, I am proud to say that all 850 acres I farm are enrolled in the CSP program.

Chairman HARKIN. Good for you. Thank you.

Mr. REHERMANN. The USA Rice Federation is the global advocate for all segments of the rice industry. Our multi-billion-dollar industry provides jobs and income for a broad and diverse array of people in the value chain. Beyond our obvious economic and nutritional benefits is the fact that we provide winter-flooded habitat for important species of migratory waterfowl and other species. That habitat is critical to their very survival.

Our objections with climate change legislation as recently passed by the House lie in the area of increased production costs. Hopefully, our own Congress will not approve legislation that will have, may have the unfortunate, albeit unintended, consequence of shifting rice production to our foreign competitors because we can no longer compete.

The U.S. rice industry is already faced with the importation of some 750,000 tons of rice per year from foreign origins, and, therefore, competing in our own markets has become more difficult. And as that happens, the natural consequence of that would have an effect on the Nation's ability to provide food security. That would be placed at further disadvantage.

We currently have few, if any, opportunities in rice production to further sequester or reduce greenhouse gases. However, on a

proactive basis, work is newly underway in California to develop computer modeling techniques to quantify greenhouse gas emissions and, accordingly, to estimate emission responses to possible changes in cultural practices. All factors will be evaluated to determine their feasibility.

However, as of now, we cannot identify a way to offset the increases in production costs of rice attributed to H.R. 2454. Moreover, the much discussed study by Texas A&M demonstrates that on all rice farms sampled, production costs will go up significantly, and that causes our bottom line to reduce significantly and ultimately has an effect on equity.

The American Farm Bureau Federation estimates that just the increase in rice production cost per acre could reach as high as \$153 per acre. Within that margin lies any ability we have to show a profit.

Additionally, we consider it highly unlikely that rice-producing countries with whom we compete will impose onerous regulatory burdens, as evidenced by historical evaluation. Therefore, we respectfully urge the members of this Committee to fully evaluate alternative approaches to curbing greenhouse gas emissions and to oppose pending or similar climate change legislation.

We have some suggestions that we would like to make today, but in the event that legislation similar to H.R. 2454 is considered in this body, we believe there are several key provisions which must be clearly and explicitly included in the bill to help ensure U.S. agriculture is not irreparably injured in the process.

One, a specific exemption should be included for the agriculture sector from the greenhouse gas emission reduction requirements of climate change legislation and the underlying Clean Air Act.

Second, a definition of "agriculture sector" for the purposes of this exemption should be clarified to include production as the path from the field through the stage of processing necessary for the commodity to be marketed in commercial channels.

We will need additional funding to accomplish more research by USDA and the land grant university system. We need the establishment of a program using the funds and authorities of CCC to compensate producers for their increased input costs. We would like to see the establishment of a robust agricultural offset program that is flexible and run entirely by the USDA.

In conclusion, I urge this Committee to work and the Senate to postpone consideration of climate change legislation until such time that alternative legislative approaches for curbing greenhouse gas emissions are developed which do not injure American agriculture. If this effort, however, is unsuccessful, we request that this Committee work with other committees of jurisdiction and your Senate colleagues to ensure that our recommendations are included in any climate change legislation enacted into law. We believe that these provisions in the current approach to climate change would be very detrimental to the U.S. rice industry.

Again, thank you for the opportunity to present our views. I will be glad to answer any questions.

[The prepared statement of Mr. Rehermann can be found on page 116 in the appendix.]

Chairman HARKIN. Well, thank you, Mr. Rehermann, for being here and thank you for your testimony.

Now we turn to Mr. Luke Brubaker of Brubaker Farms of—*is it Mount Joy, Pennsylvania?*

Mr. BRUBAKER. Mount Joy, right.

Chairman HARKIN. Mount Joy, Pennsylvania. Welcome, Mr. Brubaker. Please proceed. I am sorry. I was looking at your folder here.

STATEMENT OF LUKE BRUBAKER, BRUBAKER FARMS, MOUNT JOY, PENNSYLVANIA

Mr. BRUBAKER. Thank you, Chairman Harkin and Ranking Member. And I am so disappointed my Pennsylvania Senator just left me earlier, and all the rest of the members, I was going to address them, but they have gone.

Chairman HARKIN. That is all right.

Mr. BRUBAKER. I would like to thank you for the opportunity to speak before you today about the issue of global warming. I do not come here today as an expert on global warming, but to tell you some of the great things that happen on Brubaker Farms, and I believe that we can have an impact on the atmosphere and on global warming.

To begin, I would like to speak with you about Brubaker Farms Dairy and dairies in general and how they can profit from the product—manure—which, in some cases, is thought of as a liability rather than an asset.

I like to think of myself not just as an environmentalist, but also as a business leader where I can lead in the local community and represent dairy farmers on State and national issues. Please refer to my short bio which I believe you received.

Brubaker Farms of Mount Joy, Pennsylvania, is owned by my wife and myself, in partnership with our two sons, Mike and Tony Brubaker. My father purchased the farm in 1929 and started the operation with eight cows. My brother and I purchased the farm in the early 1960's, and at that time it was an animal operation that consisted of 18 cows. In the early 1990's, my sons graduated from college and wanted to come back to the farm to be a part of that operation. At that time, my brother sold his interest in the farm to me and my sons, and we entered in to a formal partnership to manage Brubaker Farms. At the time the partnership was formed, the Brubaker animal operation consisted of 200 cows. The farm now consists of over 800 cows, 600 young stock, and also a 250,000 bird broiler chicken operation per year. These expansions to the operation allow it to provide the necessary income to sustain the three families that now rely on it for their economic well-being.

We have developed an operation that is both financially stable and is an important part of the local economy. We have taken actions to ensure that the site is maintained as a working farm in the future through participation in the Pennsylvania Farmland Preservation Program. In order to address farm commodity price issues, farm expenses, and family financial needs, we are ready to make the necessary business decisions to ensure that the farm will continue to be viable into the future. The farm is a family business, and the economic viability of the operation is critical in order to

allow it to continue to be an effective business well into the future, and for it to be an economically sustainable family enterprise.

The most recent project we have completed is a manure digester. We are excited about what this new addition means to our farm and to the energy security of Lancaster County, Pennsylvania, and neighboring communities. At the present time, our digester is generating approximately 4 to 5 megawatts of electricity a day. Most of the electricity that we generate is sold back to the local electric utility company, PP&L. We have the capacity of producing enough electricity to supply approximately 150 to 200 homes a day, and most of that is closer to 200 homes a day now.

Key to the methane production is the cows and heifers. The manure flows by push and gravity to a recovery pit where it is pumped into a large lagoon of approximately 700,000 gallons and where bacteria in the lagoon converts volatile solids in the manure into biogas or methane gas. The lagoon is completely covered and insulated. The gas flows underground into the generation building which houses a large Guascor engine and generator capable of producing 225 kilowatts.

Now I would like to speak to some of the advantages of a methane digester: reduces the strain on the PP&L grid; reduces the need for electricity produced from fossil fuel power plants; reduces pathogens in the digested manure; separates the solids from liquid and recycles the solids for bedding; reduces the odor by 75 to 90 percent after digested; fly larvae are killed by the digester, resulting in less flies; reduces methane and other greenhouse gases into the atmosphere; weed seeds killed in digested manure which in turn can reduce chemical use; selling electricity to the local power company as renewable energy.

We are permitted to add food by-products that can be metered to the manure which makes extra electricity; possibility of partnering with cafeterias to use food scraps added to manure rather than land filling which also makes electricity. In turn, this can result in a profit to the farmer.

Methane is one of the potent greenhouse gases. It is 20 to 23 times more powerful in trapping heat in the atmosphere than carbon dioxide. We make a profit from the sale of carbon credits to industry or individuals who need or want to offset emissions.

As a greenhouse gas, methane differs from carbon dioxide in an important way. Methane remains a climate change threat in the atmosphere for a number of years.

The reduction in the methane from our digester can lead to a slowing of climate change. Use of the manure after it goes through the digester is readily available to plants for plant food, which in turn helps prevent leaching and a chance for run-off.

As you know, in this critical time, the dairy farmer has some financial difficulty. Some of the things we talked about today could help the dairy producer. And as a side note, I would be happy to offer suggestions or ideas that could help correct the dairy situation.

I believe that over the next 10 years, environmental and renewable energy issues are going to be some of the biggest challenges for agriculture and farmers. Using State and Federal funding and loan assistance for this project and our new solar project to produce

electricity for about 150 homes on the roof of our new heifer barn helps Brubaker Farms make our goals a reality.

I believe investing in projects like these is good for the future of the dairy farmer industry and livestock industry, the economy, the environment, and the whole world.

I will be glad to answer any questions that you might have, and thank you again for the opportunity to speak today.

[The prepared statement of Mr. Brubaker can be found on page 71 in the appendix.]

Chairman HARKIN. Well, Mr. Brubaker, thank you very much. Very stimulating. Very stimulating.

Now we turn to Mr. Fred Yoder, Past President of the National Corn Growers Association, from Plain City, Ohio. Welcome, Mr. Yoder. Please proceed.

STATEMENT OF FRED YODER, PAST PRESIDENT, NATIONAL CORN GROWERS ASSOCIATION, PLAIN CITY, OHIO

Mr. YODER. Chairman Harkin, Ranking Member Chambliss, it is a pleasure to be here. Unfortunately, somebody has to be last, and I guess today I was the last one. I guess I am just lucky.

Again, my name is Fred Yoder. I grow corn, soybeans and wheat near Plain City, Ohio, and I have been an active participant in climate change discussions for many years. In December, I had the opportunity to attend and participate in the United Nations World Climate Conference in Poland where I was able to discuss the role of agriculture in reducing greenhouse gas emissions. Also, in addition to being part of NCGA's efforts, I serve on the boards of numerous ad hoc groups, including the 25x25 Carbon Working Group and the Ag Carbon Market Working Group here in D.C.

I feel strongly that agriculture needs to be considered a significant part of the broader solution as we evaluate ways to reduce greenhouse gas emissions. Our Nation's farmers can play a major role in the market-based cap-and-trade system through sequestering carbon on agricultural lands. In fact, numerous economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap-and-trade program for consumers.

In the near term, greenhouse gas reductions from livestock and agricultural conservation practices are the easiest and most readily available means of achieving reductions on a meaningful scale. The EPA estimates that ag and forestry lands alone can sequester at least 20 percent of all annual greenhouse gas emissions in the United States.

Further, agricultural producers have the potential to benefit from a properly crafted cap-and-trade system. Given these opportunities, it is critical that any climate change legislation seeks to maximize agriculture's participation and ensure greenhouse gas reductions while also sustaining a strong farm economy.

For years, corn growers have adopted conservation practices such as no-till or reduced tillage which result in a net benefit of carbon stored in the soil. In fact, on my farm, I engage in both no-till and reduced tillage. Also, for the past 5 years, I have worked with my State association, the Ohio Corn Growers, on a research project with Dr. Rattan Lal of the Ohio State University on soil carbon sequestration research. As part of our research, we have on-farm

plots at six different locations to study various soils and their carbon capture capabilities. I have been actively engaged from the beginning in defining the research protocols, and this is just one example of the proactive steps our industry has taken.

NCGA was pleased with the inclusion of a number of agricultural offset provisions during the House negotiations on H.R. 2454. However, we currently have a neutral position on the legislation until we finish conducting an economic analysis of the House bill. We expect to have preliminary results of our study coming in the next few weeks, which will better explain the potential cost increases and income opportunities for corn production under the American Clean Energy and Security Act. We must get this nailed down.

Perhaps one of the largest unresolved issues in H.R. 2454 is the treatment of early actors and the definition of "additionality." Producers who have taken steps to sequester carbon or other greenhouse gases should not be at a competitive disadvantage by being excluded from selling credits for future offsets that occur as a result of ongoing efforts. The House bill acknowledges this by allowing the generation of new carbon credits for producers who initiated sequestration practices as early as 2001; however, NCGA does not believe that this language is inclusive enough.

Planting and tillage decisions are made each and every year, and there is no guarantee that a producer will decide to continue the same practice as the previous season. Each and every crop we grow sequesters additional carbon, and Congress should not establish policies that offer perverse incentives to producers to discontinue their conservation practices.

To that end, NCGA supports the development of an "avoided abandonment" offset credit so that no-till producers can participate in a carbon market for their ongoing sequestration activities regardless of when that practice began.

As an aside, the House-passed version of H.R. 2454 also includes an important provision related to the Renewable Fuels Standards. The House bill prohibits EPA from considering indirect land use change when conducting their life cycle analysis for corn-based ethanol until a peer-reviewed study can be conducted to verify the scientific accuracy of the model.

NCGA disputes recent data that would suggest direct correlation between domestic ethanol production and international deforestation. The language in the House bill is a step in the right direction toward sound science and a more rational life cycle analysis. We would urge that the Senate include the same provision in its version of the climate bill.

In conclusion, it is our hope that we can continue to work with the Senate Agriculture Committee to ensure Congress chooses the best path for agriculture and rural America. I thank the Committee for its time, and I do look forward to your questions. Thank you.

[The prepared statement of Mr. Yoder can be found on page 132 in the appendix.]

Chairman HARKIN. Well, thank you very much, Mr. Yoder. Thank you all.

I will just start with you, Mr. Yoder, on what you just kind of closed on. The whole idea of stackability is one that we have looked at, and we will be making, obviously, strong recommendations on

that so that a farmer might be able to get CSP-type payments and do other things and still get to be able to get offsets for carbon sequestration. That is a little bit easier than the early actors.

Now, the early actors, as you point out, was under 2001, I think it is in the House bill.

Mr. YODER. That is what was in the House bill.

Chairman HARKIN. But what about the case of the forester we had here in an earlier panel we had in July, where he is the third generation—I forget. They had 1,000 acres of timber or something like that, but they do other kinds of farming, too. Obviously, it has been in their family a long time. Obviously, they are sequestering carbon. If he cuts down all those trees and plants new ones, he gets to sell offsets. If he does not, he gets nothing. So I think that whole thing has to be addressed because that is a pretty permanent practice to have timber like Senator Lugar has on his farm. So both of those, you raise those issues, and they are very important issues to us.

Mr. Brubaker, very stimulating, what you are doing there. I guess the question I would have is: How have your neighbors in Lancaster County who also raise livestock, how have they reacted to the addition of a methane digester to your operation? There are other dairy farmers around you.

Mr. BRUBAKER. Right. There are many dairy farmers. If Lancaster County was a State, we would be, I think, about number 11, maybe number 12 now. If just Lancaster County was a State, for the number of dairy cows, we would be about number 11 in the United States. So, yes, there are a lot of dairy farmers around, and we are getting a lot of interest in building methane digesters. They are coming from Vermont. They are coming from Minnesota. They are coming to look at our digester. And we are not the only digester in the United States. Do not misunderstand me. I think there are about 110 digesters, give or take, in the United States. But we just built this probably about 2 years ago—well, about a year and a half ago we built it. We started thinking of this in about 2006. I guess that was when milk prices were a little weak then, and we thought, “We have got to find another profit.” And we decided it would be a profit coming from the back end of the cow, and so we decided to build a methane digester, which we are getting so much interest in. Our power company in Pennsylvania is paying us a good price for electricity, and that is what I hear around the country, that power companies are not paying a good price for electricity. They are paying us a good price for electricity, and we are selling carbon credits, and it is a win-win situation.

So that answers some of your question.

Chairman HARKIN. I assume you are just running the methane through, what, kind of an engine or something that is turning, a generator? Is that the way you are doing it?

Mr. BRUBAKER. Yes. If you look on the back side of the paper that I—that is actually the picture of the digester right there. And from that digester there, you will see over there at the far left, there is some piping that runs about a 6-inch pipe over into an engine room, which runs a big, almost a 400-horsepower Guascor engine, which runs a generator, which we are selling the electricity right onto the grid.

Chairman HARKIN. Is this economically viable to do something like this? Can you actually make money on something like this?

Mr. BRUBAKER. Well, yes, we are making money on it, and that is why people are looking at it. We did have—in about 2006, Governor Rendell was out to the farm for a meeting, myself and my two sons and the two Secretaries of Agriculture. We took a little trip after the talk, and we sat him beside the manure pit, and we told him what we want to do. He did some writing and said he wants to look into this situation. It was not too long until Pennsylvania had a Harvest grant. We got a Harvest grant, and we also got a grant from USDA which made it work for us to take the risk to build a digester, which it cost about a million and a quarter to do. But if everything goes well, the way we are producing, we are way above expectations on producing electricity, and we should pay it off in 3 to 4 years. And if we would not have had the grants, I believe we could have paid it off—could pay it off in, to be conservative, 8 to 10 years.

Chairman HARKIN. Mr. Rehermann, again, one of the benefits of having you here is, again, to highlight the fact that different parts of agriculture do not fare as well under the proposed legislation, and one of those that has come to our attention are the rice farmers.

I have heard mention of methods to reduce methane emissions from rice farming. I guess that comes from the straw or something? I do not understand that. But are there any kind of practices like that that would be viable as an offset practice for rice farmers?

Mr. REHERMANN. For approximately, Mr. Chairman, the last 30 years, we have investigated methods by which we can rid ourselves of our straw, which yields about 3 ton per acre, a good rice crop. We have sought alternative uses, and to date, we have no feasible, large-scale alternative use for rice straw. And so most of it is incorporated into the soil. Certainly that leads to methane gas production.

We continue that plight. We continue to search, but we have no real evidence that we are going to be able to sequester or reduce the emissions any more than we do.

We irrigate. We are under constant irrigation. We use a fairly high amount of nitrogen. We till the soil. Our soils are heavy clay and not well drained. All those things lead to the emission.

Chairman HARKIN. Again, it is a balancing here that we are trying to do here. There have been, obviously, a lot—well, I have gone over my time. I am sorry. I was not paying attention to the clock. I will finish there, and if I have a follow-up, I will follow up later.

Senator Chambliss?

Senator CHAMBLISS. Well, gentlemen, thanks for your testimony here today. Mr. Yoder, always good to see you.

We have talked about the study that Texas A&M did that has just been released in which there is a very distinct difference in farmers who would prosper from this versus farmers who would struggle from it. We heard some of that from you folks here.

We have got to develop a policy that hopefully will benefit all farmers and ranchers across America and not just a policy that is going to—in this case, as the Texas A&M study showed, would particularly benefit Midwest farmers and corn and soybean farmers.

Do you have any advance understanding of what your study is going to show with respect to this particular piece of legislation and its effect on corn that may be grown in Georgia or North Carolina versus corn that may be grown in the Midwest?

Mr. YODER. Well, I cannot really say for sure what the study that we are doing right now will say, but I will say this: With our work in Ohio with Dr. Lal from Ohio State, there is a definite difference in soil's ability to sequester carbon. So there will be some differences across the country. It is not going to be one size fits all. In fact, if Senator Johanns was here, in the sandy soils of Nebraska it would be virtually impossible to generate a credit from soil sequestration because of the sandy soil, the lack of organic matter.

However, the study that you are referring to from Texas A&M really only looked at two types of offsets, and that was no-till sequestration and also methane digesters. And so it was really kind of narrow in scope.

The other thing, too, that we have to consider is that in the Waxman-Markey bill there were 13 different projects that they listed as projects for agriculture to participate, and it is much broader than just no-till sequestration or methane digesters. For instance, raising a cover crop or reducing the amount of water that you irrigate with, with maybe some varieties that take less water, reducing nitrogen use and things like that.

So I think the thing we have to do in order to make this work for all of agriculture is to come up with scientifically based verifiable projects that we can do clear across the United States and not put one part, like Georgia, at a disadvantage compared to an Iowa or something like that. I think we have the science to do this, but I think it is important for your Committee to really work on broadening this and making sure that we have some science-based projects that everyone can participate in and not just a few.

Senator CHAMBLISS. All of the testimony thus far that we have heard indicates very strongly that we are going to see a rise in input costs. Apparently, nobody is in disagreement with that, whether it is nitrogen or petroleum or whatever it may be. So in order to continue to generate a profit from a corn-growing standpoint, obviously you are going to have to get a higher price for it, which we all assume that would be a likely scenario. Otherwise, as the Texas A&M study showed, the only way you are going to see corn and soybeans prosper is for acreage to come out of production, which means farmers going out of business.

Mr. Brubaker, if that scenario does play out and we see a significant increase in corn prices—we have heard testimony that we are going to have an increase in electric prices, we are going to have an increase in the other feedstuffs that you use in your production. With the dairy market in very tough times right now, what is that going to do to your operation?

Mr. BRUBAKER. Well, maybe we are in a better position than some, but I want to try to look at it as the whole picture of dairy and livestock producers. Maybe one thing you could do would be if a farmer participates in the carbon sequence in one way or another, that you would offset his expenses, his fuel expenses or something like that, if that is going to raise fuel and electric costs.

I am just trying to think of something that would offset it. Exempt that farmer if he participates in the program, offset his fuel prices, electric prices, or doing something like that. Maybe that is an opportunity, or maybe that is an encouragement.

Senator CHAMBLISS. Well, we are in an atmosphere, unfortunately, that rather than increasing subsidies, we keep getting shot at from the standpoint of decreasing subsidies. And it makes it pretty difficult.

Frank, good to see you as always, too. Thanks for being here. The Texas A&M study as well as other studies have shown that rice farmers are not going to fare too well for the reasons that you enumerated. What is this going to do to you and the international market? If the United States forges ahead with a cap-and-trade program, where are rice growers in this country going to be from a global market standpoint?

Mr. REHERMANN. Senator Chambliss, we cannot help but be severely disadvantaged by that if we lose our ability to compete in that global marketplace, and we are constantly being reminded that in order to effectively compete, we have to be a lower-cost producer than trending higher. We have had the same impacts on our input costs, the energy-related input costs that every other business in the United States has had. The principal difference, as you know, is that we cannot pass those costs along to the consumer.

So I peril to think of the disadvantage we are going to be in the export market. We are having a more and more difficult time, as I mentioned, competing against imports into this country.

Senator CHAMBLISS. Well, and I know some of the difficulties you are experiencing now. The last couple of years have been pretty tough years in the rice industry from a global competition standpoint. And if we are looking at increasing your input costs without seeing a collateral increase in prices, are we going to see more and more rice growers go by the wayside?

Mr. REHERMANN. I fear that in this country you will. I think that the people who will benefit will be the growers in the countries that do not implement such onerous regulations, our competing nations—Vietnam, Thailand, Burma. If China and India export, we have big trouble there. I do not look for them to lead the way in climate change initiatives.

Senator CHAMBLISS. Mr. Beckstoffer, I am particularly interested in how a small California winegrape grower can provide offsets under this cap-and-trade program. Can you tell us what emission reduction or carbon sequestration activities winegrape growers are doing now and what they can do under an offset program? And I apologize. We just do not grow a lot of grapes over our way. A lot of muscadines, but not grapes, are used extensively in the manufacture of wines. So educate us a little bit about what you are doing and what can be done.

Mr. BECKSTOFFER. We do not plant grapes but once every 40 years, so that we do not do new things that often. So as many of the people on this panel have said, if our early practices where we sequester carbon every year based on what is already in the ground is not give credits, we are not going to get many credits, because we simply do not do that.

What we do for reasons of grape quality, if you will, and soil conservation is that we—we are very worried about compaction and things of that sort, so we do not drive tractors that much. We are worried about pesticides, so we grow cover crops so we can host beneficial insects and things of that sort. We use drip irrigation so we do not use a lot of energy to irrigate. But all of those are practices that we do every year, and so somehow or another, we must get credit for the photosynthesis and for the carbon sequestration we do with our normal business practices, and that for plants that are planted every 40 years, as Mike Thompson was saying, we do this precision ripping, and that cuts down on tractor usage. It cuts down on carbon because you are actively—you are turning the soil.

But we started that because the rocks were really big and it cost a lot of money to move those rocks. But most of the things we do for wine quality and for soil conservation are things that would help climate control, plant and carbon sequestration. But you have got to give us credit for what we do every year, or we are not going to get much benefit.

Senator CHAMBLISS. All right, Mr. Chairman, I think that is all I have right now. Thank you very much, gentlemen.

Chairman HARKIN. I have another one to ask Mr. Beckstoffer, and that is, it seems to me that you are in a unique position. Your vines are long-term type, carbon sequestration, 30, 40 years on some of these vines. Do I assume that you also—do you do any kind of cover crop in between your vines and stuff like that?

Mr. BECKSTOFFER. Yes, we do, and we do that—what we do is we do it to dry out the soil. We plant the kind of crops that would dry the soil in the spring and then would go away when the plant needs the soil in the rest of the summer, because in California we get rain from November to March and not any time in between that. But our vineyards are—there is a cover crop between the rows that we mow and we do not turn the soil anymore. We mow it, and we mow it only, say, once a year because the kind of crops we do die in the summertime because we do not want to use the soil—we do not want them taking up our soil moisture.

But if you would look at a vineyard, you would see—we plant over 1,000, 1,200 vines per acre, so that is very intense in terms of the green foliage there, which is the photosynthesis. But the ground much of the year is green as well.

Chairman HARKIN. Well, thank you all very much. I just have to respond to my friend from Georgia here on this issue of the increased input costs and the increased price for feed for our dairy farmers or hog farmers or cattle farmers.

Senator Thune and I just had a hearing out in Sioux City here a week or so ago on energy, basically biofuels, and it was stated there by not only growers but some of the representatives of our big seed manufacturers that 300 bushels per acre of corn is not too far in the distance. In fact, I think it was—let me see. It was DuPont or the other one, Monsanto—I forget which one—which they predict that by 2020—they did not predict. They said it is certain that we will have a 40-percent increase in the productivity of corn per acre in this country. And that is not even taking into account some of the genetic research that is going on now, in corn especially. I am probably particular to corn because of Iowa, but corn

where they are developing strains of corn that use less water, that can grow in different parts of the world with less water. Some of it may even be brackish-type water that the plant can utilize like—I always point out there are some plants that produce fruit or something that use sea water, but they have a gene in there that says, “Salt, you stay here, and we will take the fresh water.” And they are finding that—like coconuts being, of course, the most obvious one. So if you can find those kinds of genes that we could help introduce, then we could grow corn in a lot of different areas that we are not growing it now.

So we are going to have—I am told it was Monsanto who said that we will have 300 bushels by 2030. Pioneer said we would have a 40-percent increase in 10 years, so that is basically equivalent from both of them. So there is a lot of—we are going to produce a lot more corn per acre in the future. And that is good. That is very good for all of us. So I do not think we have reached the limits of our research yet on those areas.

Well, thank you all very much; this has been very helpful to us, all your testimony. Rest assured we are trying to figure out how we can give the best information possible to the other committees when they bring this up—sometime, I do not know when, maybe this fall.

Thank you all very much, the Committee will stand adjourned.
[Whereupon, at 1:06 p.m., the Committee was adjourned.]

A P P E N D I X
SEPTEMBER 9, 2009

(57)

SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
Global Warming Legislation: Agricultural Producer Perspectives and Trading Regulation Under a Cap and Trade System
Wednesday, September 9, 2009 — 10:00 a.m.
216 Hart Senate Office Building
Opening Statement—Senator Kirsten Gillibrand

Thank you Mr. Chairman and thank you for holding this important hearing.

Thank you also to the witnesses here today to help us understand the market we will be creating under this bill. Understanding how this legislation will impact, manufacturers, farmers, and energy producers who will depend on this market is critical for ensuring its success.

I would also like to particularly thank Chairman Gensler for his work and attention on this issue. He brings a wealth of experience to this issue and has been consistently generous with his time and energy in helping to analyze this new market.

I believe that reducing the emissions that cause global warming is a critical goal for environmental and national security reasons. But I also believe that a cap and trade system, setting our country clearly on a path away from fossil fuels, provides our country and the State of New York with strong economic opportunities. If we move swiftly to seize them, we can fuel our economy for decades to come.

Today, and over the weeks and months to come, I am going to continue to listen carefully to concerns from farmers and businesses and work to ensure that all New York industries thrive under a new cap and trade system.

In recent months, New York has suffered with the traumatic repercussions of last fall's financial crisis. As the global home of finance, New York has lost tens of thousands of jobs and billions in income as a result of financial collapse.

A cap and trade system and the well-regulated trading and financing of carbon and carbon offsets offer a much-needed growth opportunity for New York's financial sector.

According to some estimates, carbon is expected to rapidly become the world's largest commodities market if the United States enacts cap and trade legislation and, like other commodities users, companies using carbon permits will depend on the financial sector to provide liquidity in the market and manage risk.

The financial sector will also play a critical role in financing clean energy investments and fueling innovation. Firms looking to reduce their carbon footprint will depend on the financial sector to provide them the necessary capital. Farmers looking to sell carbon offsets will also depend on the financial sector to fund the new practices that can sequester carbon and reduce global warming.

Our success in combating climate change will in large part depend on our ability to fund carbon reduction projects. To be successful, we must create a quality regulatory regime for carbon that instills confidence in potential investors around the globe and protects American farmers and consumers.

We need to empower regulators to take action to control excessive speculation and market manipulation to prevent unnecessary spikes in the price of carbon permits. We must require transparency in the marketplace and provide regulators the tools to take action to ensure a smooth-functioning market.

At the same time we need to create a regulatory regime with sufficient flexibility to allow businesses to develop new technologies and make long term investments.

Firms looking to make these types of investments need to be able to manage their carbon risk over the long-term in a way that standardized products may not allow. Similarly, the offset projects that we must encourage our nations farmers to embark on may require highly customized financial products.

To achieve both these goals we must also bring real regulation to the market for customized products. This will mean creating new transparency requirements, so regulators and the public can monitor risks being taken, and pricing such transactions to reflect their higher risk.

We should also work to integrate our efforts into broader reforms of the derivatives market, to ensure a fair playing field and prevent opportunities for market manipulation or arbitrage. In doing so we need to take advantage of new and innovative techniques that will reduce the costs of trading and improve the ability of compliance entities to manage their risk.

Finally, we must act quickly to seize this opportunity. Across the globe, other countries have begun to take steps towards establishing a robust carbon market. The European Union has established a market worth more than \$90 billion. Other countries – including China – have taken significant steps towards building the infrastructure to take advantage of carbon trading.

To ensure the economic and environmental success of cap and trade, we must harness the resources of the financial sector to help make the investments we need to ensure a clean energy future.

The financial sector is just one important sector of New York's economy that will benefit from a cap and trade regime. New York is also one of the nation's leading agriculture and forestry states with a diverse output ranging from wine grapes and dairy products to maple syrup, timber and apples.

Failure to act on climate change could lead to devastating results for New York's farmers, who produce billions of dollars worth of products that nourish our families and construct our homes.

A change in temperature of even a few degrees will greatly impact the temperamental crop of New York's grape producers. The expanding geographical range of invasive species such as the Emerald Ash Borer poses unprecedented risks for New York's 18.5 million acres of forestland. Our coastal regions are under threat of increased flooding and our water-rich inland regions could very well see drought.

In addition to protecting the long-term viability of the agriculture industry in New York State and throughout the nation, this legislation also promises the opportunity to realize a new revenue stream to help our farmers. This is especially important in a state like New York, where small, family-owned, specialty crop producers do not typically receive the same level of public support as farmers in other parts of the country.

Investments in methane digesters, non-food based biofuels and other methods of alternative energy generation promise to provide a new direction of growth for New York's agriculture and forestry producers and their communities. In addition to reducing our reliance on foreign oil and cutting US greenhouse gas emissions, a growth in the clean energy sectors will provide thousands of good jobs to ensure the continuing viability of our rural communities.

I will continue to work with my colleagues to ensure that New York's specialty crop producers and small forest owners are included in any discussions about offset programs. Many of the producers have been participating in voluntary initiatives and other good land management practices for many years. These individuals are innovators and pioneers, who should not be forgotten when we begin discussing incentives.

I would once again like to thank the panelists for taking the time today to come and discuss these very important issues with the committee today. I look forward to working with you as this legislation moves forward.

Senator Chuck Grassley
Statement
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
September 9, 2009; 10:00am

Thank you Mr. Chairman and Ranking Member Chambliss for calling this second hearing of the Committee on climate change. I think it's critical that all views and facts get reviewed by this Committee before we move forward on any legislation.

I also want to make a special welcome to David Miller of the Iowa Farm Bureau who will be on the panel following Mr. Gensler. Thank you for being with us today.

It's especially important that we hear directly from producers at the grass roots. Just last week we saw the positive impression that can be left on federal officials when the EPA accepted my invitation and visited Iowa.

The EPA officials heard straight from the mouths of farmers the impact that rules and regulations made by the agency can have on families and their livelihoods.

The stakeholders shared wagonloads of information, statistics, and real life examples that helped the group understand and learn the issues at the farm level. The EPA asked a lot of questions, appeared to take the message from our family farmers to heart, and promised further dialogue with our producers and stakeholders.

I hope this same process resonates with our committee members and the producers today. I like to think of farmers and ranchers as the original environmentalists of our country.

Farmers know that if they don't take care of our natural resources, their land and livestock will not be productive and their greatest resource will be destroyed.

I think farmers would be the first to endorse a realistic approach to concerns about the climate.

But if we ask our farmers to take on overly burdensome expenses, for an exercise that doesn't include an international agreement, we would be asking them to put themselves at an economic disadvantage to the rest of the world for no real environmental gain.

I look forward to hearing from all of our witnesses today about the benefits to farmers in climate change legislation, but also the real and serious challenges it poses for rural America and your recommendations to address those issues as the Senate moves forward on climate change legislation.

SENATOR THUNE'S OPENING STATEMENT:

I would like to thank the Chairman and Ranking Member for holding today's hearing. I'd also like to thank the panels of witnesses for their thoughtful testimony.

Over the coming months, the United States Senate will likely consider legislation aimed at curbing greenhouse gas emissions, primarily carbon dioxide.

Such a bill will have a dramatic impact on virtually every part of our economy.

In particular, agriculture, which is an energy intensive industry, will be greatly impacted by this legislation.

It is the responsibility of this committee to determine if America's farmers and ranchers will experience a net gain or net cost under a future cap and trade system.

Without question, ALL producers will experience increased input costs. The cost of diesel fuel, gasoline, electricity, and fertilizer will increase at time when our agriculture producers can least afford it.

However, some producers may be able to benefit from planting trees or practicing conservation management activities.

Who will bear the costs and who will reap the benefits are all but settled questions this committee must address.

Additionally, the Senate Agriculture Committee must ensure that the Commodity Futures Trading Commission is prepared to take on the additional burden of regulating what some are predicting to be a multi-trillion carbon market.

What responsibilities should be assigned to the CFTC? What have we learned from the recent financial crisis in the derivatives market? Will the CFTC be prepared for such a historic task in just a few short years?

These are all answers that must be addressed by this committee the near future.

Additionally, I am hopeful that this committee will take this opportunity to address other issues impacting our agriculture producers and our renewable fuels industry:

I believe Congress must act this year to expand the definition of renewable biomass to include federal forestlands and additional private forestlands.

I also believe we should work to address the troubling consequences of indirect land use change calculations in the expanded renewable fuels standard. This was a failed experiment that should be eliminated as soon as possible.

Testimony of W. Andrew Beckstoffer before the
Senate Committee on Agriculture, Nutrition and Forestry

September 9, 2009

My name is Andrew Beckstoffer. I live in St. Helena, a small agricultural town in the Napa Valley of California. Our family farms winegrapes, a specialty crop. Thank you so very much for the opportunity to testify before this distinguished Committee of the United States Senate regarding climate change.

There are almost 24,000 grape growers in the United States. The full economic impact of US wine, grapes, and grape products on the American economy is estimated at \$162 billion. Grapes are the highest value fruit crop in the nation and the sixth largest crop overall. Grapes are grown in more than 40 states, and they account for about 30% of the value of all fruits grown in the United States. Grapes are a significant part of the Specialty Crop segment of the U.S. Agricultural economy. Specialty Crops represent approximately 50% of the farm gate value of total plant agricultural production while occupying only about 3% of the nation's harvested cropland.

It is widely documented by medical journals that wine is good for your heart. I truly hope that is so. For sure, grapes, peaches, pears, carrots, lettuce, tomatoes, and all fruits and vegetables are specialty crops that provide essential nutrition to the American people. That is where their real importance lies.

The Napa Valley is widely known as a premium winegrape growing region. What is not so widely known is while some 9% of Napa County's land mass is devoted to vineyards, over 10% of the county's land is protected by some sort of open space conservation arrangement. Conservation and environmental sensitivity are hallmarks of our lives in the wine region. The increased tax incentives on conservation easements that Congress provided in the 2006 legislation has made a major contribution to our ability to conserve agricultural lands. In our small valley, over 1,650 acres have been placed under Conservation Easements since 2006, including 330 of our own. These are major incentives which expire this year. I hope that you will extend them beyond 2009.

WAB 9/9/09

Something else beyond nutrition and conservation is important to me. President John Kennedy said that any generation will be less known for the wars they won than for their contribution to the cultural heritage. Over the past 30 years California's fine wines have equaled in quality and often exceeded the finest wines of Europe in critical tastings. The world must now consider the American contribution to this cultural arena along with our technical, economic and military might. Winegrapes are a Specialty Crop with unique national significance.

In considering my testimony before you today I was struck by four major concerns.

FIRST, in the most recent National Farm Bill, Specialty Crop concerns received \$3 billion, just one percent of the \$289 billion approval. Specialty crops represent the most agricultural worker jobs, and produce much of America's nutrition. Somehow, considering the vast economic and nutritional value of specialty crops, I do not feel that they got a fair share in the Farm Bill. My point here is not to revisit the Farm Bill but to urge that Specialty Crops receive fair consideration as you enact Climate Change legislation.

SECOND, Specialty Crops growers are generally relatively small farmers. Our family is the largest family vineyard owner in the Napa Valley and on the North Coast of California. In total acreage we list behind only two large international wineries. On any statistic involving all farms, however, we are small farmers. That is the case with most Specialty Crop producers. We are scattered politically and geographically and do not have the organization or capacity to compete with the large program crops for adequate consideration in major legislation, such as that involving Climate Change. Without your special indulgence and careful consideration, much of this nation's nutrition engine will suffer.

THIRD, it has been widely reported that many car dealers have opted out of the "Cash for Clunkers" program because of the heavy documentation requirement on their limited staffs. We have a similarly limited staff. I would hope that the reporting requirements of any Climate change program would be held to the minimum.

WAB 9/9/09

FOURTH, USDA's Economic Research Service reports that between the years 1997 and 2002 some 8 million acres of America's farmland have been lost to agriculture due in good part to urbanization and economic pressures. In California, our population of 37 million is estimated to double in 25 years to 70 million people. This is nearly 25% of the entire population of our country today! In that short period of time, it is reported that California could lose as much land to development as we did from the gold rush of 1849 to the year 2000!

In the beautiful Napa Valley, some 60 miles from San Francisco, there is tremendous urban pressure. It is my view that winegrape vineyards here are the long-term highest and best economic use of the land. For that reason we have been able to preserve our vineyard lands. This is true in varying degrees in all agricultural lands near urban areas. These lands in many cases are relatively small Specialty Crop lands. It is widely anticipated that state and federal carbon reduction programs will increase costs for energy, fertilizer, pest management tools and other inputs as well as transportation. If winegrape growers and agriculture are not excluded from any carbon emissions cap while being able to receive credits for offsets provided, these unaddressed increased costs will result in the loss of an additional increment of agricultural lands.

Further, it is my understanding that agriculture, through plant and soil sequestration, has been identified as a priority area for "cap and trade" offsets. If the profitability of agriculture is further decreased through increased costs and competition from foreign wines made with cheap labor and government supports, that will serve to limit the availability and expansion of agriculture as an important component of any "cap and trade" program.

The winegrape quality and standards in the Napa Valley are in no immediate or short-term danger from Climate Control activity. Certainly regional statistics on average degree days do not tell the Napa Valley story. For example, 1988 and 2005 were two of the warmest years on record in California. Because of the influence of the fog brought on by our proximity to the San Francisco Bay and the coast, these were two of the coolest growing seasons in the Napa Valley. This does not mean that we are not being affected or that there will be no long-term effect. We deal in vintage years, each of which

WAB 9/9/09

seems to be different. However, something is changing overall.

For example, we are experiencing more heat spikes. Generally speaking, heat and sunlight bring beneficial effects to grape ripening and maturity. We prepare our trellises and canopy management to accept and accentuate this. When heat spikes occur, they damage the grapes, and thus we must prepare our trellises to avoid sunlight and heat—in direct contradiction to our main objective of heat and sunlight accumulation.

The nights are getting warmer. The secret of producing great winegrapes involves achieving a chemical balance between sugar, acid, and pH. Sugar is accumulated during the sunlight hours, acid by the cool nighttime temperatures, and pH at both times. Climate change is increasing our nighttime temperatures, which at this time has an unknown effect on grape balance and quality. We need research to show these effects and the interaction of our different vineyard management systems. I understand that much of the carbon sequestration research has been done on annual crops. Our vines with a 20 to 40 year lifespan have a significantly different carbon footprint, and their relationship to annual crops should be analyzed.

Another area where Climate change is beginning to affect us is pest infestation. The disruption in the ecosystem is producing new pests and mutations and vine diseases that we do not yet understand. This could have a major effect on our ability to limit pesticides.

For reasons of economics, fruit quality, and soil and water conservation, we have, over the past many years, drastically reduced our tractor usage in the vineyards. In the 1980s Napa Valley vineyards were infested with a devastating root disease. In the 1990s we replanted almost the entire valley with new vines and techniques designed to improve grape quality, reduce vine and soil manipulation, and improve conservation of natural resources. At Beckstoffer Vineyards we use only about 50 pounds per acre of nitrogen fertilizer per year. This is far less than most crops. We limit our irrigation practices for reasons of fruit quality and use efficient drip irrigation when we do irrigate. We make extensive use of cover crops to host beneficial insects and limit pesticides as well as reduce tillage to limit

WAB 3/9/09

moisture evaporation. We in the winegrape business have for many years been adapting practices that sequester carbon. Hopefully, these early practices will be recognized in any potential carbon market or offset program.

Most of what we have been doing and currently do to reduce greenhouse gases is done to achieve fruit quality, to improve soil and water conservation, and for economic reasons. Only a very foolish farmer, without consideration of future generations, would not seek to save his soil and his water. As concern for Climate Change intensifies, our adherences to those practices and our curiosity about how to improve them increases.

California winegrape growers are national leaders in utilizing and promoting sustainable practices.

We at Beckstoffer Vineyards have participated along with 1,500 other growers representing 68.3% of the total 523,000 California winegrape acres in the California Sustainable Winegrowing program. This program provides self assessment of sustainable practices that are environmentally sound, socially acceptable and economically feasible, and offers concrete suggestions of how to improve. We are also in the process of converting two-thirds of our vineyard acreage to Certified Organic status.

Finally, it is my belief that we as Americans made great progress in the 20th Century. Amazing things were done in the fields of transportation, communications, armament, technology and agriculture. We should be congratulated! But in doing so, in many cases, we dried up or polluted our water, eroded our soils, and fouled our air.

Your hearings today are an obvious recognition of these facts. In the 21st Century we must continue to make progress, but preservation, conservation and environmental sensitivity must be a new requirement. We in the winegrape business are anxious to play under those rules. Given our scattered political voice and historic small share of economic and policy incentives, however, we do need your careful consideration and indulgence as you prepare a policy for Climate Change. I thank you again for

allowing me to testify today, and for your interest in the winegrape industry. I look forward to your help in allowing us to sustain our contribution to the national health and welfare.

Washington DC testimony 1sep109

WAH 9/9/09

**PRODUCER PERSPECTIVES
AS THEY RELATE TO DAIRY FARMS
AND
GLOBAL WARMING**

Chairman Harkin, Senator Casey and Agriculture Committee Members:

I want to thank you for the opportunity to speak before you today about the issue of global warming. I do not come here today as an expert on global warming, but to tell you some of the great things that happen on Brubaker Farms, and that I believe we can have an impact on the atmosphere and global warming.

To begin, I would like to speak with you about Brubaker Farms Dairy and dairies in general and how they can profit from the product (manure), which, in some cases, is thought of as a liability rather than an asset.

I like to think of myself not just as an environmentalist, but also as a business leader where I can lead in the local community and represent dairy farmers on state and national issues. Please refer to my short bio which I believe you received.

Brubaker Farms of Mount Joy, Pennsylvania, is owned by my wife and me, in partnership with our two sons, Mike and Tony. My father purchased the farm in 1929 and started the operation with eight (8) cows. My brother and I purchased the farm from our father in the early 60's, at which time the animal operation consisted of 18 cows. In the early 90's, my two sons graduated from college and wanted to come back to the farm to be a part of the operation. At that time, my brother sold his interest in the farm to me and my sons, and we entered in to a formal partnership to manage Brubaker Farms. At the time the partnership was formed, the Brubaker animal operation consisted of 200 cows. The farm now has over 800 cows, 600 young stock, and also a 250,000 bird broiler chicken operation per year. These expansions to the operation allow it to provide the necessary income to sustain the three farm families that now rely on it for their economic well-being.

We have developed an operation that is both financially stable and is an important part of the local economy. We have taken actions to ensure that the site is maintained as a working farm in the future through participation in the Pennsylvania Farmland Preservation Program. In order to address farm commodity price issues, farm expenses, and family financial needs, we are ready

to make the necessary business decisions to ensure that the farm will continue to be economically viable in the future. The farm is our family business and the economic viability of the operation is critical in order to allow it to continue to be an effective business well in the future, and for it to be an economically sustainable family enterprise.

The most recent project we have completed is a manure digester. We are excited about what this new addition means to our farm and to the energy security of Lancaster County, Pennsylvania and neighboring community. At the present time, our digester is generating approximately 4-5 mw (megawatts) of electricity a day. Most of the electricity that we generate is being sold back to the local electric utility company, PPL. We have the capability of producing enough electricity to supply approximately 150-200 homes a day.

Key to the methane production is the cows and heifers. The manure flows by push and gravity to a recovery pit where it is pumped into a large lagoon of approximately 700 thousand gallons and where bacteria in the lagoon converts volatile solids in the manure into biogas or methane gas. The lagoon is completely covered and insulated. The gas flows underground into the generation building which houses a large Guascor engine and generator capable of producing 225 kw (kilowatts).

Now, I would like to speak to some of the advantages of a methane digester:

- Reduces the strain on the PPL grid
- Reduces the need for electricity produced from fossil fuel power plants
- Reduces pathogens in the digested manure
- Separates the solids from liquid and recycles the solids for bedding
- Reduces the odor by 75 to 90% after digested
- Fly larvae are killed by the digester, resulting in less flies
- Reduces methane and other greenhouse gases into the atmosphere
- Weed seeds killed in digested manure which in turn can reduce chemical use
- Selling electricity to the local power company as renewable energy
- We are permitted to add food by-products that can be metered to the manure which makes extra electricity.
- Possibility of partnering with cafeterias to use food scraps added to manure rather than land filling which makes electricity. In turn, this can result in a profit to the

farmer.

- Methane is one of the potent greenhouse gases. It is 20 to 23 times more powerful in trapping heat in the atmosphere than carbon dioxide.
- We make a profit from the sale of carbon credits to industry or individuals who need or want to offset emissions.
- As a greenhouse gas, methane differs from carbon dioxide in an important way. Methane remains a climate-change threat in the atmosphere for a number of years.
- The reduction in the methane from our digester can lead to a slowing of climate change.
- Use of the manure after it goes through the digester is readily available to plants for plant food, which, in turn helps prevent leaching and a chance for run-off.

As we all know, in this critical time, the dairy farmer has some financial difficulty. Some of the things we talked about today could help the dairy-livestock producer. As a side note, I would be happy to offer suggestions or ideas that could help correct the dairy situation.

I believe that, over the next ten (10) years, environmental and renewable energy issues are going to be some of the biggest challenges for agriculture and farmers. Using state and federal funding and loan assistance for this project and our new solar project to produce electricity for 150 homes on the roof of our new heifer barn helps Brubaker Farms make our goals a reality.

I believe investing in projects like these is good for the future of the dairy industry's economy, environment, and the entire world.

I will be glad to answer any questions you might have.

Thank you again for the opportunity to speak today.

Luke Brubaker
September, 2009

STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
September 9, 2009

Good morning Chairman Harkin, Ranking Member Chambliss and members of the Committee. Thank you for inviting me to testify today regarding cap-and-trade legislation before Congress. My testimony will focus on the Commission's experience regulating emissions trading markets and how we can apply that experience to trading in government-issued greenhouse gas allowances and offset credits. In the event that Congress passes cap-and-trade legislation, the Commodity Futures Trading Commission has the necessary expertise to regulate trading in the expanded carbon markets.

Before I turn to the carbon markets, I am pleased to report to you that the CFTC has been very active since the last time I testified before this Committee. Since then, we have held three hearings into whether or not to set position limits in the energy markets like we do in the agriculture markets. We have worked with the Treasury Department to deliver legislative language to the Congress that would regulate over-the-counter derivative markets. We have revised a no action letter and reached an agreement with the United Kingdom Financial Services Authority to enhance our oversight of a foreign board of trade. We have withdrawn two additional "no action" letters that permitted traders to exceed position limits in some of the agriculture markets. We have improved our transparency efforts by disaggregating the data in

our weekly Commitments of Traders reports. And just last week, we held unprecedented meetings with the Securities and Exchange Commission on how we can better harmonize our regulatory structures to most benefit the American public.

Over the past year, we have witnessed the consequences that regulatory gaps and inconsistencies can have on our financial system, the economy and the American people. As Congress moves forward with potential cap-and-trade legislation, I believe it should ensure that there is a comprehensive regulatory framework over the expanded carbon markets – both the futures market and the cash market – without exception.

Proposed cap-and-trade initiatives would impose a ceiling on the total amount of greenhouse gasses that covered entities can emit and expand the market for pollution rights, which are known as “allowances.” An allowance is a limited authorization by the government to emit a quantity of carbon dioxide equivalent. The allowance could be traded, used by regulated parties to comply with emissions caps or potentially banked. Along with allowances, cap-and-trade programs for greenhouse gases utilize “offset credits” – credits given for activities that reduce, trap or sequester carbon.

It is crucial to ensure that the carbon market functions smoothly, efficiently and transparently. Effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are five regulatory components of carbon markets that I believe should be considered:

1. Standard setting and allocation;
2. Recordkeeping (maintaining a registry);
3. Overseeing trade execution system;
4. Overseeing clearing of trades; and
5. Protecting against fraud, manipulation and other abuses.

The first two components – the actual allocation of allowances and offset credits, and recordkeeping (other than recordkeeping of the trades) – fall within the expertise of other agencies. In other words, others are better equipped to regulate the “cap” part of “cap-and-trade.”

For example, the EPA currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain, NOx Budget Trading and Clean Air Market Programs. On a smaller scale, a conglomeration of ten states in the northeast and mid-Atlantic form the Regional Greenhouse Gas Initiative and issue allowances on greenhouse gas emissions. In each case, other entities issue allowances and maintain the registry. The constant, however, is that the CFTC regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the “trade” part of “cap-and-trade.”

Specifically, we have broad experience in the latter three components of carbon trading: regulating trade execution systems and clearing of trades and guarding against fraud, manipulation and other abuses. The Commission already oversees trading and clearing of futures and options contracts based on sulfur dioxide, nitrogen oxide and carbon dioxide

allowances and offsets listed on the New York Mercantile Exchange and the Chicago Climate Futures Exchange. Additionally, just last month, under direction from Congress in last year's Farm Bill, the Commission put out a proposed determination for public comment to classify the Carbon Financial Instrument contract traded on the Chicago Climate Exchange as a significant price discovery contract. This would give the CFTC full oversight authority over the contract, giving us additional experience regulating cash emissions contracts. The Commission has abundant experience in the regulation of centralized marketplaces, and should Congress seek to regulate cash markets for emission instruments, the Commission is well-suited to carry out that function.

In most respects, emissions contract markets operate no differently than the other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, soybeans, treasury bills or natural gas – presents its own unique challenges, the regulatory scheme is essentially the same. Carbon markets have similarities to several different markets that fall within our regulatory authority. For example, carbon allowances and offsets are similar to agriculture commodities in that there is a yearly “crop” and important programmatic regulations governing the nature of the product. At the same time, carbon contracts have similarities to financial products. For example, government-issued allowances and offset credits would be similar to Treasury-issued debt instruments. Futures contracts on Treasury debt are among the most actively traded CFTC-regulated products.

The emissions trading markets that the CFTC currently regulate are small relative to the expected growth of the carbon market as a result of cap-and-trade legislation. Still, the agency has the expertise to apply the same oversight to the much larger, national and mandatory market.

The Commission has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, that products are designed to minimize potential manipulation and that exchanges comply with the law and regulations. The Commission's compliance staff actively monitors operations to ensure that exchanges are enforcing their rules and that customers are protected from abusive practices. The oversight of clearing is an integral part of the CFTC's regulatory structure. The Commission has extensive experience and a well-established program to ensure derivatives clearing organizations and clearing firms have safeguards to ensure orderly clearing and settlement of transactions and safekeeping of customer funds. Our surveillance staff keeps a close eye for signs of manipulation or congestion and determines how to best address market threats. We have the authority to set and enforce position limits, and our enforcement staff is actively prosecuting cases. In the past year, the CFTC has expanded the scope of its existing energy advisory committee to create the Energy and Environmental Markets Committee, which significantly enhances the CFTC's ability to anticipate and address the full panoply of regulatory issues pertaining to emissions trading markets.

The CFTC has wide-ranging transparency efforts designed to provide as much information to the American public as possible. Specifically, the Commission publishes weekly Commitments of Traders reports, which, starting last week, include disaggregated data to more

accurately depict the makeup of the futures and options markets. The Commission also publishes quarterly data on index investment, a "This Month in Futures Markets" report and annual financial data for futures commissions merchants and futures industry registrants.

Should Congress pass cap-and-trade legislation, the CFTC would work with other regulators and market users to ensure that all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis. With immediate registry of trades, it will be easier for regulators to identify manipulation in the markets.

The CFTC, however, would need additional resources for new staff and technology to effectively regulate the expanded carbon markets. The Commission is just this year getting back to the staffing levels that it had in the late 1990s. Since then, the markets grew five-fold and the number of contracts grew six-fold, but the agency's staff was cut by more than 20 percent. To take on additional oversight responsibilities, we will continue to work with this Committee and the Appropriations Committees to secure additional resources.

As Congress moves forward and possibly enacts cap-and-trade legislation, I look forward to working with this Committee to ensure that the new markets are comprehensively and effectively regulated. The CFTC is the exclusive regulator of futures markets. I believe that we have the expertise and experience necessary to help regulate the growth in carbon futures and cash markets that will occur if cap-and-trade becomes law. We must protect against the same

hazards in the carbon markets that we currently guard against in other commodity futures markets: fraud, manipulation and other abuses.

Thank you for inviting me to testify today, and I look forward to your questions.

Testimony of Joseph R. Glace
Vice President and Chief Risk Officer, Exelon Corporation
Before the Committee on Agriculture, Nutrition, and Forestry
United States Senate
September 9, 2009

Mr. Chairman and Members of the Committee:

My name is Joe Glace, Vice President and Chief Risk Officer of Exelon Corporation. Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, ComEd, which serves northern Illinois including the city of Chicago, and PECO Energy, which serves southeastern Pennsylvania including the city of Philadelphia, together serve 5.4 million customers, or about 12 million people – more than any other company in the United States. We have fossil, hydro, nuclear and renewable generation facilities. Our nuclear fleet is the largest in the nation and the third largest in the world. I have worked in the energy field for 29 years. At Exelon, I am responsible for leading our risk management function, including the identification, assessment and monitoring of market, credit, and operational risks.

In my testimony today I want to highlight Exelon's:

- Support for comprehensive climate legislation;
- Opposition to requiring all trading, derivatives, and hedging activities to be conducted on exchanges;
- Support for expanding the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter (OTC) market; and
- Support for reporting requirements for OTC transactions in the carbon markets

Exelon was an early and vocal advocate of climate change legislation. We have testified in favor of passage on several occasions. Our CEO, John W. Rowe, first testified in favor of addressing climate change by means of a carbon tax in 1992. We are pleased that the House has passed a comprehensive climate and energy bill and look forward to working with this Committee and the Senate to pass comprehensive, cap-and-trade legislation this year.

Exelon supports an economy-wide bill with realistic targets and timetables, an effective cost containment mechanism, such as a cost collar, and allocating electric sector allowances to regulated local electric utilities with a requirement that the value represented by the allowances is used to provide benefits to customers.

To better understand Exelon's views regarding regulation of the carbon market and the concerns that are the intended focus of this hearing, I think it is important to explain briefly Exelon's overall approach to commodities trading. We are not speculators. We use commodities trading to reduce the price risk we face as an electric generation company. That is, our primary objective is to reduce the risk to our revenues that we would face if we were completely subject to the sometimes sharp fluctuations in short-term, spot market power prices.

Let me delve into this a bit further. A substantial majority of our generation fleet is located in the geographic footprint of what are known as "regional transmission organizations" or RTOs. RTOs are regulated by the Federal Energy Regulatory Commission or FERC. RTOs operate competitive markets for wholesale energy and capacity. Accordingly, unless Exelon does something about it, Exelon is completely exposed to the ups and downs of the short-term, spot market energy prices in those markets. That is, we could make a lot of money if the spot prices turn out to be high, or lose a lot of money if they turn out to be low. Because we are not speculators, however, we are not willing to take that gamble. Instead, our business model is to lock in, or hedge, the price we are paid for the electricity we generate.

We do this by buying and selling energy products that are available in the commodities markets. For example, we might sell an amount of electricity for one agreed price for all hours in the summer months of June through September. We will then know that we will always get that price for that amount of electricity during those four months. We forego the prospect of getting higher prices absent the sale, but, and more importantly, we avoid the risk that prices will fall below the fixed price we are paid by the buyer of the electricity. We also can do the same thing with respect to the fuel we buy to run our

plants. We might transact in the OTC market for coal to lock in our fuel cost for our coal plants.

An increasingly large percentage of our hedging transactional activity is in the markets for purely financially-settled swaps and options, or derivatives, where the underlying reference commodity is usually electricity, natural gas, oil, or coal. For example, we might enter into a swap pursuant to which a counterparty pays us \$25 per megawatt for 50 megawatts of electricity per hour for every hour in the month of July, and we pay the counterparty the spot market price that we are paid by the RTO for the electricity we have actually generated. The result for us is that we are guaranteed that we will be paid \$25 per megawatt of electricity – no more and no less. The counterparty makes money if the spot prices we pay it turn out to be higher than \$25 per MW, and loses money if the spot prices are lower than \$25 per MW. No physical electricity actually changes hands; rather, only an exchange of revenue streams happens, based on an underlying variable commodity price (the spot market price of power). Exelon gets a fixed revenue stream and the counterparty gets, and takes the risk associated with, a variable revenue stream determined by the spot market price of power – a risk that Exelon would otherwise take but for the transaction.

Our customers benefit from this hedging and trading activity. We are in a position to agree to longer term power sales contracts with both wholesale and retail customers; the price terms under those contracts are in large part possible because of the relative price stability hedging provides to our portfolio. It is our experience that retail customers in particular want prices for power sales to be stable rather than subject to the fluctuations of the spot market. Without hedging and trading we simply would not be able to do that.

One of the principal concerns many have expressed with adopting a carbon control regime is how it will affect our fragile economy. We at Exelon believe that the economic impact of a comprehensive program will be manageable if the legislation includes the elements outlined above and if it provides the mechanisms necessary for a robust allowance trading program, including derivative products derived from those allowances. Simply put, a properly regulated, robust trading program, plus liquid trading

markets, will help control the overall cost of the program. That is why it is important to view the issues before this Committee, which are the topic of today's hearing, from the customer's perspective. What steps should the Congress take to effectively regulate and ensure the integrity of carbon trading markets without imposing undue costs on consumers?

Our strongly held view is that any regulatory reform of the commodities markets should ensure that the products which we use to prudently hedge our business risks remain available to us and at a cost that is comparable to the costs we face today. This means that we believe it would be a mistake to force most, if not all, derivative hedging transactions like the ones I just described to exchange-traded platforms such as the New York Mercantile Exchange (NYMEX), or to require that all bilateral or OTC derivative transactions be cleared through exchanges like the NYMEX. We enter into futures contracts on the NYMEX, and also clear some transactions with NYMEX and other clearing platforms, but a substantial component of our derivatives hedging program is in the OTC market without clearing.

Transacting on exchanges is much more expensive than in the OTC markets because it requires posting of substantial amounts of cash as collateral. This is one reason we do not – in fact cannot – conduct all of our hedging activity on exchanges. The OTC market enables us to transact with creditworthy counterparties without having to post potentially huge amounts of cash collateral but also without taking on any materially greater amount of default risk. We can more efficiently husband our cash by using other forms of payment security and collateral to secure some of our risks bilaterally in the OTC markets, including letters of credit, payment guarantees, and pre-payment arrangements. Were we to have to move all of our hedging to exchanges, any move in price could require additional cash outlays in the hundreds of millions of dollars range, and possibly even in the billions. This, in turn, would mean that we would have to charge substantially more for our product – electricity – which means our customers would have to pay substantially more for this vital commodity.

The same is true, albeit indirectly, of any requirement to clear OTC derivatives. Counterparties will be loathe to clear materially larger volumes than they do currently, because once cleared, their counterparty becomes the exchange, and the more costly posting requirements applicable to exchange-traded transactions would then kick in.

Another drawback of limiting hedging activity to exchanges and clearing platforms is that these entities will only offer futures for, or provide a clearing platform for, a standardized set of products. Exelon enters into customized transactions that get us a lot closer to completely eliminating the particular price risk we are trying to hedge than would one of the standard products that would regularly trade on exchanges.¹

To draw the obvious conclusion – power prices will be higher, meaning that consumers will ultimately pay more than they would otherwise, if companies like Exelon are forced to do all of their hedging on exchanges and clearing platforms.

Exelon is not alone in its opposition to requiring all transactions to go through exchanges. I want to draw your attention to a recent letter sent to all senators by a large group of trade associations representing the energy sector, rural electric cooperatives, and consumer groups, a copy of which is attached to this testimony. It raises the same concerns about the increased costs of dealing primarily through exchanges and clearing platforms that I have explained, and therefore shows that there is a broad consensus among energy suppliers and consumer associations that forced exchange trading and mandatory clearing is not the way we should address the concerns that this committee is tackling.

¹ As noted in a recent briefing paper published by the Pew Economic Policy Department, “[e]conomic efficiency is harmed if those with commercial needs for hedging are forced entirely into standard derivatives positions that are relatively poor hedges, or if derivatives markets are unable to innovate along with changes in the economy.” Darrell Duffie Dean Witter Distinguished Professor of Finance at Stanford University’s Graduate School of Business, (2009), “How should we regulate derivatives markets?,” Pew Briefing Paper # 5, Pew Economic Policy Department, p. 18. See http://www.pewfr.org/admin/task_force_reports/files/Pew_Duffie_Derivatives.pdf

Exelon believes there are better ways to protect commodity markets from the risk that some entities may try to manipulate them, and from the more fundamentally systemic risk that the country faced as a result of the unregulated and frenzied speculative trading that went on in the credit default swap markets. To explain what we think would make the most sense, I now turn to the question at hand – what to do about the coming market for carbon emissions allowances.

The carbon cap and trade proposal that Exelon supports, and that is contemplated in the legislation passed by the House, will immediately result in a large, new market for carbon allowances. One of the critical electricity consumer-protection features of the House-passed bill is the provision that would require allocation of 30% of the allowances - which recipients would receive at no cost - to regulated local distribution utilities. This proposal has very broad support, ranging from investor-owned utilities, electric cooperatives, and municipals, to state regulators and consumer advocates. The local distribution utilities are not “covered entities,” to borrow a term of art from the House bill; that means they will have no compliance obligation, and therefore will not “need” the allowances they receive for compliance purposes. The utilities, however, would be required to ensure that the benefit of those allowances goes to their customers. Every state, and the District of Columbia, has a public utility commission, or PUC. The PUCs regulate the local utilities and have authority to ensure that the customers do, indeed, benefit from the allowances. In the case of Exelon, our distribution utilities, PECO and Com Ed, will sell the allowances, and then the Pennsylvania and Illinois PUCs will oversee the use of the proceeds to ensure that they will benefit customers. One way they will consider to accomplish this result will be to use the revenues to reduce customer rates. They could also require the revenues to be used for financial assistance to customers who need it or energy efficiency programs.

Generation-owning entities like Exelon, as well as other emitters, will need to procure allowances to comply with carbon emissions caps; we and other generators will be covered entities. In this regime, the cost of carbon allowances will be a cost of doing business for generators. It will be just like the cost of gas, oil, or coal – an input that is necessary to enable us to make and sell our

product. And Exelon will need to hedge the price risk associated with that product. That will mean that Exelon will want to have as wide a range of options as it currently does to hedge its fuel price and power price risks, meaning the full array of both exchange-traded and OTC offerings that now exist.

We recognize, however, that in this new market as in others, there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps that can tempt unscrupulous traders to manipulate markets and force prices above appropriate market levels.

That is why we support the expansion of the CFTC's jurisdiction to the new market for carbon allowances, including the OTC market that will certainly develop. This should allay any concern that speculators could artificially drive up the price of both the derivatives used to hedge the cost of carbon allowances in OTC markets, and the price of the allowances as such. The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to OTC markets, and perhaps revised and refined to ensure that they provide to the CFTC the tools it needs to prevent manipulation.

For the same reason, Exelon also supports the adoption of new reporting requirements for OTC transactions in the market for carbon allowances. The CFTC has to have access to information about transactions to enable it to fulfill its regulatory oversight and enforcement function. Also, the obligation to report, as such, will be a powerful deterrent to would-be manipulators.

In addition, Exelon appreciates the critical nature of the country's need to prevent, for all time, the kind of crisis we faced last year, which revealed to all that unbridled trading activity could pose potentially catastrophic systemic risk. Accordingly, in addition to comprehensive transaction reporting requirements, Exelon supports the development and establishment of rules and guidelines that the CFTC would use to "stress test" the riskiness of the portfolios of major swap dealers and participants active in the carbon markets,

and in particular of those whose primary business, unlike Exelon's, is to make markets and trade derivatives for their own account.

I appreciate the Committee's invitation to testify today. You are dealing with an extraordinarily complicated subject area. I hope that I have provided you with a sense of why it is important to ensure that there is effective oversight of the emerging carbon markets while at the same time guarding against over-regulation that would result in higher costs for companies like Exelon and in turn for our customers. I would be pleased to answer any questions you may have.

Joint Association Letter Regarding the OTC Derivatives Issue

July 10, 2009

Dear Senator:

The undersigned energy supplier and consumer associations represent all the major segments of the electric power and natural gas industries serving virtually all of the consumers in the United States. We are writing to express our concern with certain aspects of proposals to address oversight and transparency of over-the-counter (OTC) energy markets. While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets and to prevent excessive speculation, it is essential that policy makers preserve the ability of companies to access critical OTC energy derivatives products and OTC energy commodities markets. We rely on these products and markets to manage risks to help stabilize and keep energy costs low for consumers.

The members of the associations represented on this letter use the OTC markets to hedge a variety of risks associated with energy production and fuel costs. We use OTC contracts to help insulate our business and customers from excessive price volatility.

Specifically, we are concerned with proposals to impose mandatory clearing of all OTC transactions, as well as requirements to force OTC derivative transactions to be moved onto an exchange. We believe that such proposals would significantly increase costs for companies seeking to hedge risks through OTC products, as well as greatly limit, or eliminate altogether, needed customized products used for risk management for the following reasons:

- The high cash margin requirements of a clearinghouse or an exchange would significantly increase transaction costs, and tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industries need to invest billions in new energy infrastructure.
- At the same time, since clearinghouses and exchanges require a high level of standardization and liquidity in the derivatives and commodities products traded, we believe that such proposals would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks. For example, in the case of electricity, the prerequisites for standardized and centralized clearing are missing, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets.

Ultimately these increased costs and risks will be borne by all consumers. We believe that there are far better ways to accomplish the goals of greater transparency and effective regulatory oversight of OTC energy derivatives and commodities markets without mandatory clearing or forcing these products to be moved onto an exchange. We would welcome the opportunity to discuss these issues with you.

List of supporting associations:

| | |
|--|---|
| American Gas Association | Interstate Natural Gas Association of America |
| America's Natural Gas Alliance | Large Public Power Council |
| American Exploration & Production Council | National Association of Manufacturers |
| American Public Gas Association | Natural Gas Supply Association |
| American Public Power Association | National Rural Electric Cooperative Association |
| Edison Electric Institute | US Chamber of Commerce |
| Electric Power Supply Association | US Oil & Gas Association |
| Independent Petroleum Association of America | |



**Statement of the
Iowa Farm Bureau Federation**

**To the Senate Committee on Agriculture, Nutrition & Forestry
Full Committee Hearing**

**Global Warming Legislation: Agricultural Producer Perspectives
and Trading Regulation Under a Cap and Trade System**

Presented by

**David Miller, IFBF Director of Research & Commodity Services
and Chief Science Officer AgraGate Climate Credits Corporation**

Wednesday, September 9, 2009 — 10:00 a.m.

216 Hart Senate Office Building

Thank you very much for this opportunity to present testimony and discuss issues regarding market structure and market performance as it pertains to carbon markets. My name is David Miller and I am the director of research and commodity services for the Iowa Farm Bureau and the Chief Science officer for AgraGate Climate Credits Corporation, an affiliated company of the Iowa Farm Bureau. AgraGate is one of the leading aggregators of carbon credits from U.S. agricultural and forestry lands under the existing protocols of the Chicago Climate Exchange. We provide the means for thousands of farmers and landowners across more than 30 states to access the existing voluntary carbon markets. We help them enroll, quantify and verify their potential carbon offset credits so that they can be registered and marketed to entities that have a need for such.

I also farm. On our 400 acre farm in southern Iowa we converted to continuous no-till in order to qualify to earn carbon credits under CCX rules. I am one of thousands of U.S. farmers, forester and ranchers, who work more than 16 million acres, that have been paid for providing environmental services through the CCX enrollment, verification and carbon credit sales process. (See Figure 1) Our credits can be sold to any of the 400 plus legally-approved members of CCX, including companies, governments and universities that legally commit to reduce their emissions, as well as investors and others. While I have served for over six years on various governing committees at CCX (There have been more than 300 committee/subcommittee meetings in the past 6 years – the CCX system is not “set it and forget it.”), I am speaking today on behalf of AgraGate and Iowa Farm Bureau.

Occasionally, we have been asked why all of the credit registrations we have done have been on the Chicago Climate Exchange. The simple answer to that is that CCX has the only protocols that are “workable” for production agriculture and private forest lands. Various aspects of the protocols of other registries have design elements that limit their acceptance by offset providers.

Market design and structure matter and are critical to market performance. Some of the items that I would like to discuss today include market transparency, offset protocol standards and the critical need for fungibility of compliance offsets.

Pricing Transparency

Market transparency is critical to smooth operation of a carbon market. Transparency means that not only must there be a clear enumeration of what criteria are used to define offsets, but that there must be mechanisms in place so that prices (bids, offers and sales transactions) are publically reported and readily available. The only market that currently offers that transparency is the Chicago Climate Exchange. The electronic trading platform was very transparent about bids, offers and actual transaction prices. On the exchange, all of the compliance instruments were equal and fully fungible. Under that condition, the members of the CCX that needed compliance credits could buy excess allowances or any type of offset that was registered with the exchange and know that their compliance commitment would be met. Unfortunately, that pricing transparency has been sharply curtailed. Under the provisions of H.R. 2454 (The American Clean Energy Act of 2009), there is language that suggests that domestic offsets from current registries may be exchanged or recognized in the federal regulatory program, but it does not provide specific indication that allowances from CCX will be recognized. This

differentiation has resulted in all offset transactions moving to bi-lateral, privately negotiated trades where the buyer can be assured that they will receive offsets rather than any CCX compliance instrument as might be the case on the electronic platform.

To improve transparency, CCX rules have been updated to require that all privately negotiated trades be reported to the exchange and they post these trades daily. But, the bid-ask spread has widened significantly and the market has fragmented such that the offsets from soil are valued differently than the offsets from forestry which are valued differently than the offsets from methane destruction, etc. In fact, there is even differentiation of value based on the geographic location of the offset project. This has increased the transaction costs associated with marketing carbon offsets and has reduced the net returns to the actual offset project owner.

Regulatory uncertainty is now harming the thousands of U.S. farmers and companies who have taken the lead in building rules-based carbon markets. It is extremely important to provide a smooth transition for those who are making emissions reductions in CCX and other verified programs so that continued progress on their part can be made to reduce emissions.

Other carbon registries have little or no pricing transparency. There is no public record of the bids, offers or transaction values of offsets registered and retired on the Climate Action Reserve, the APX-Voluntary Carbon Standard or CDM projects. The lack of market pricing transparency means there is much less information available to market participants and tends to shift undue market power to large traders to the detriment of project owners and smaller participants.

Fungibility of Compliance Offsets

Fungibility of compliance offsets, where a registered offset credit equals a registered offset credit regardless of the source of the credit, is a market design characteristic that is essential if the transaction costs of the carbon market are to be minimized. Fungibility of offsets will foster efficient market operations and enables transparency since it is conducive to trading of the compliance instruments on electronic exchanges with full pricing transparency.

"Term Credits" as delineated in H.R. 2454 are not fungible compliance instruments. They only delay compliance obligations. They do not satisfy compliance obligations. They are an inferior product and based on the experience of temporary credits under the European trading system, they will have little or no value. It is extremely problematic that H.R. 2454 has relegated all soil sequestration offsets, by design, to the class of term credits. It is neither necessary nor desirable from a market design perspective to address the issue of permanence in this manner. There are better ways to address that issue and a discussion of a better approach is contained in our written comments. In our analysis, we believe term credits will be highly discounted by the marketplace, especially if the expectation is that credit prices in the future will be higher. Relegating soil offsets to term credits will minimize the participation of working farmlands in carbon offset markets.

Offset Design Criteria

According to the EPA analysis, biological sequestration represents upwards of 90 percent of the expected total offsets during all timeframes outlined in the ACES legislation. Thus from a macro perspective, biological sequestration is the linchpin of an effective domestic offsets program for the agriculture and forestry sections. Bio-sequestration offsets are the only means by which domestic offsets can deliver low cost, near term and high volume GHG reductions, all critical requirements in allowing the uncapped sectors of the economy to facilitate the capped sectors' transition to a low-carbon future.

Offset sources need clear, simple, protocols, or rules, which define eligible practices and associated record keeping. The cost of perfect information is usually too high. So, reasonable compromises, including conservative carbon accumulation rules, must be employed

Design criteria for offset protocols can "make or break" the viability of agricultural and forestry offsets as real tools in the effort to reduce atmospheric carbon. To be viable, offsets must be designed for "working lands." It is the active growing of crops, grass, and trees that will take the carbon from the atmosphere in the first place. The income from these production activities is essential to the sustainability of the carbon-sequestering activity. Private farmlands and forests are not preserves – and we don't want them to be if we want to have affordable food, fiber and fuel. Income from carbon offset credits is quite likely to be the incremental incentive that will entice participants to take on the costs and liabilities that compliance with multi-year offset protocols will require. But the carbon offset income is highly unlikely to be sufficient, by itself, to sustain the dedication of the land to these carbon sequestering activities. No-tilling crops like corn, soybeans, barley or wheat will not only sequester carbon in the soil, enhancing that resource for generations to come, but also helps the world by producing food on the most productive lands in the world rather than having fragile lands degraded by subsistence agriculture.

But, to be a workable part of the solution, carbon offset protocols must work within the framework of existing agricultural markets. Length of contract matters. In Iowa, more than 60 percent of the farmland is rented by the operator with the vast majority of that land on one-year renewable leases. In our experience of working with farmers on carbon offsets, the number one reason why a farmer would NOT participate in a carbon offset program is the length of contract. Even the 5-year contract that we use in connection with the CCX protocol is long enough that many farmers believe it adds enough liability that they cannot participate. It is difficult to commit to being fully liable for reversals that can create backward looking liability for 5 years when the lease agreement that governs control of the land is for a shorter period of time. And it is unlikely that the emergence of a carbon market will result in a wholesale change in landlord-tenant relationships and the structure of land leases. We have looked at the proposed protocols of some other registries. Some of these protocols have single term length of commitment from 20 years to 199 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long. We believe that 5-year contracts for soil sequestration (with the option of renewing the contracts) are workable, but even minimum contract length of 5-years will significantly reduce participation by active farmers.

The 15-year contract length for managed forests is of sufficient length that it is a major deterrent to participation by private landowners. Sure there are some forest preserves and special cases

where 100-year contracts can be entered into. But our experience is that very few private landowners are willing to do so -- and the vast majority of the carbon-sequestering opportunities are on private lands. We have looked at the proposed protocols of some other registries. Some of these protocols have single term length of commitment from 20 years to 100 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long. We believe that 5-year contracts for soil sequestration (with the option of renewing the contracts) are workable, but even minimum contract length of 5-years will significantly reduce participation by active farmers.

Generalized quantification methodologies are a very effective and low-cost way to quantify soil sequestration offsets. (This is the methodology contained in the CCX soil and rangeland protocols.) Soil sequestration results from the carrying out of specific practices in conjunction with crop production. While the exact quantity of carbon that is sequestered varies across the landscape due to variations in soil characteristics, plant growth, climatic conditions, etc., across a large number of acres the actual amount of carbon sequestered will be the average of the area times the number of acres carrying out the appropriate practices. There is substantial data from a number of highly controlled research plots that provide great insight into what the average rate of sequestration is for land resource regions. Granting offsets at the average rate for a defined region (adjusted for the permanence reserve) guarantees statistically that the number of credits granted were a true representation of the actual sequestration that has occurred. Under this approach, any individual acre may actually sequester more or less carbon than the rate that is used in the generalized approach. In fact, it is quite likely that the distribution of a large number of acres will have the characteristics of a normal distribution with equal likelihood of actual sequestration rates that are above and below the average.

Don't be fooled by the "illusion of accuracy" that exists when credits are granted based on site-specific soil sampling. Generalization of site-specific soil samples and granting credits based on the results of such samples introduces much error and variation into the crediting process. The reality is that there is likely to be as much variation within an 80 acre field as there may be across a region. Using a generalized quantification approach with wide-spread participation eliminates the potential for selective sampling and skewing of the results based on sampling procedure. Plus, the use of a generalized quantification approach allows for use of satellite technology for compliance verification which can greatly reduce the costs of verifying compliance. Is there a role for soil sampling? Yes, for general monitoring of the overall effectiveness of the soil protocol, but not for granting of individual offset credits. USDA should do systematic soil sampling to monitor the progress of the soil offset protocol and to periodically adjust the generalized crediting rate. Over time, the more data points that exist, the more localized the differentiation of the crediting rate that can be established with statistical confidence.

Permanence versus Duration

While biological processes are not permanent, they do have substantial duration and the lack of permanence should not be used as a reason to restrict or limit the use of biological sequestration as carbon offsets. Attached in our written testimony is a briefing document about how an implicit "permanence reserve" can be incorporated into sequestration offset design which allows

the registered credits from sequestration activities to have the characteristics of permanence and be fully fungible with other offsets.

Credit Integrity and Offset Reversals

In order to maintain market integrity, it is essential that registered, serially-numbered offsets not be subject to de-listing due to a reversal event of a specific project. A buyer of a registered offset credit must be assured that the credit, once registered, represents a viable compliance unit and will not be disqualified after registered or purchased.

Offset providers should be fully accountable for reversals during the period of active crediting. We support the concept of a compliance reserve for biological sequestration offsets in which a specified percentage of the registered credits are held in a not-available for trading compliance reserve until the term of the crediting period is completed. The credits held in this reserve should be used to cover any reversals that may occur under a sequestration project. However, a reversal should not result in a de-listing of a registered credit. A reversal during the active crediting period should result in a requirement that the reserve account be reduced by the amount of any reversal. Once the active crediting period is completed, reserve credits should be released as available for sale. Any reversal that might occur after the active crediting period would be covered by the implicit permanence reserve that was deducted at the time of credit quantification. This assures that all registered credits have met the permanence criteria.

Market Regulatory Framework

Harm Bureau policy states, "The integrity of all U.S. commodity futures and options exchanges as a pricing mechanism must be maintained by the members of the exchanges and their overseeing governing bodies. Commodity futures and options trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. Other commodities should be included where need exists and research shows futures and options trading would be beneficial. We urge that regulatory laws be strictly enforced. We support the use of off-exchange agricultural trade option contracts in commodity marketing, which would include complete risk disclosure, vendor integrity and the opportunity for cash settlement of the option."

As is being demonstrated by the early action programs, carbon can and is becoming a commodity that can and will be traded just as other commodities. The experience of the Chicago Climate Exchange is proving that markets for carbon can and do work. (See Figures 2 & 3) While the CCX market is currently operating as an Exempt Commercial Market under the Commodity Exchange Act, its regulatory status may change as the CFTC is now assessing whether CCX performs a "Significant Price Discovery Function".¹ Based on the requirements of the regulated carbon market, contracts and services are being developed to supply projects and products that

¹ CCX also operates the Chicago Climate Futures exchange, a CFTC-regulated Designated Contract Market that is the only active marketplace for futures and options contracts on USEPA SO₂ and NO_x allowances, as well as carbon dioxide emission allowances in Regional Greenhouse Gas Initiative.

meet market requirements. However, the actual registry and retirement of allowances and offsets should be done on regulated, open, transparent markets with specified standards for price reporting that would include date of transaction, vintage, quantity and pricing information.

CFTC Regulation

The CFTC should continue in its role as the regulator of derivatives, futures and options contracts associated with carbon trading. Farm Bureau opposes efforts to combine CFTC and the Securities Exchange Commission and supports regulation of the commodity futures business by CFTC. Derivatives, futures and options on carbon contracts are not fundamentally different than other derivatives, futures or options contracts. The oversight and regulation provided by the CFTC is adequate for these markets. However, we urge CFTC to be diligent in its oversight of futures exchanges and floor traders to ensure that integrity of these markets is maintained and to curb practices that could result in manipulation or artificial price swings.

The CFTC should establish speculative position limits for carbon futures and option market with appropriate exemptions for bona fide hedgers and end-users of carbon credits. Investment and index funds should be subject to speculative position limits. To minimize the potential market distortions and/or manipulations, carbon market derivatives should be required to clear on regulated, public exchanges with full price reporting.

Similar to corn, soybeans and other agricultural commodities, the cash market transactions between farmers, ranchers, forest landowners and project developers and aggregators should be exempt from direct regulation by the CFTC. There is sufficient state contract and business law to govern these transactions.

Capital and Margin Requirements

Leverage is an issue in the financial markets. One of the major contributors to defaults of credit default swaps and mortgage-backed securities was leverage, particularly in the derivatives of these products. High degrees of leverage set the stage for small swings in market conditions to cause financial stress. It is important to note that throughout the stress in the financial markets of the past year, no defaults occurred on the regulated futures exchanges. The market structure and discipline that is imposed on these markets helped them perform while the over-the-counter market was at times in a state of disarray. Farm Bureau policy supports the governing body of the commodity exchanges to continue to establish predetermined, publicized limits for margins at various market price levels for each commodity. We believe the leverage levels of derivatives traded by major market participants should be examined and brought under greater regulatory scrutiny by the appropriate regulatory agency. Margin and capital requirements that create a strong incentive for dealers and users of derivatives to trade them on regulated exchanges or regulated electronic platforms should be developed.

USDA Administration of Offsets

As part of the regulatory structure for carbon, USDA should be charged with unique responsibilities regarding offsets. USDA should develop a set of agency-approved offset

standards and protocols for biological sequestration from agriculture and forestry and methane destruction that would be used the mandatory carbon market and could be used by voluntary carbon markets. USDA should provide the administrative support and oversight of offset standards development, review, and update and should be actively engaged in coordinating the linkage of U.S. domestic offsets with international offset markets. The agency oversees standards for grains, livestock and other agricultural markets and should be the agency in charge of setting standards for carbon market offsets.

Thank you for the opportunity to provide input and information to the Committee.

Included as part of our written comments is a summary of Farm Bureau policy regarding carbon regulation, carbon markets and commodity futures and options markets.

How Chicago Climate Exchange Contracts Create Carbon Offsets that Represent “Permanent Reductions”

- 1) At the Chicago Climate Exchange (CCX), contracts for offset credits cover a 5-year period for cropping practices and a 15-year period for forestry practices.
- 2) Under a CCX contract, an offset provider agrees to initiate and maintain a set of practice(s) that, for the contract period, reduces CO₂ equivalent emissions by a specified amount. CCX utilized a scientific panel to inform the CCX offset committee regarding the appropriate rate of carbon sequestration that would occur under various practices. The actual crediting rates utilized by CCX represent a 20% reduction from the “scientific” rate recommended by the scientific panel.
- 3) Once offset practices have been implemented and verified, the first year’s tradable offset credits are issued to the provider. Additional offset credits are issued annually for each year of the contract; under a five-year contract, a producer would receive five years of offset credits. The credits are considered to be “permanent” reductions in CO₂ equivalent emissions.² (How this works, in practice, is explained below.)
- 4) At the end of the contract period, the producer is under no further obligation to maintain the offset practices. Using a crop example, the producer has provided five years of offset services and, in return, has received five years of tradable offset credits. How then, can five years of offset practices and offset credits be considered permanent reductions?
- 5) The mechanism which causes offsets to be considered permanent reductions is that producers receive only 80% of the CO₂ equivalent reductions that the CCX calculates they have actually made. This 20% discount, in effect, provides a “Permanence Reserve” of actual offsets that have occurred but have not been credited. As long as the amount of any reduction leakage caused by producers who discontinue offset practices after their contracts expire is, in aggregate, less than the offsets in the Permanence Reserve, then, in practice, the reductions can be considered to be permanent. In other words, CCX considers that the offset reductions are permanent for the system but not for each individual contract.
- 6) The Permanence Reserve only applies to “reversals” after the end of the contract period. All offset providers are responsible for meeting the contract provisions on which their soil sequestration credits are based during their contract period. Any actions taken by an offset provider that results in a reversal while “under contract” would require a complete recovery or replacement by the offset provider of the “reversed” offsets covered by the contract. Therefore, there is full accountability by individual offset providers during the period of

² Consider a five-year CCX contract whereby a producer agrees to use no-till practices to grow his corn and soybeans beginning with the 2009 crop year. If the “actual” CO₂ equivalent reduction as determined by the CCX is one metric ton per acre per year, the producer receives an offset credit of 0.8 tons for 2009, an offset credit of 0.8 tons for 2010, an offset credit of 0.8 tons for 2011, an offset credit of 0.8 tons for 2012, and an offset credit of 0.8 tons for 2013. Over the five-year contract period, the “actual” reduction is 5 tons but the credited reduction is 4 tons.

active contracting and the systemic accountability by the Permanence Reserve for reversals that may occur after the contract period.

- 7) Note that the Permanence Reserve operates, in a sense, through a sort of “invisible hand.” Individual contracts are not tracked for permanence and offset credits are not deposited into or withdrawn from the reserve. A key question is how big does the invisible hand need to be? We believe that USDA could conduct periodic surveys to inform the system about how large of a reserve is really needed. Based on survey results of actual reversals, the discount rate could be adjusted every 5 years to reflect the true risk of post-contract reversals. In addition, incentives for contract renewal, which maintains full accountability for reversals, could be incorporated to further reduce potential post-contract reversals.
- 8) CCX believes that the 20% discount reserve is more than sufficient to offset permanently the leakage that occurs if some producers discontinue offset practices after their contracts expire. First, producers can renew a contract, continue the practices, and continue to receive credits.³ Second, if some producers stopped contracted practices after the end of the contract, the most likely practices that would replace them likely would be carbon neutral⁴—i.e., not sequestering additional carbon but not, on net, emitting additional carbon, either. Third, practices such as no-till have a propensity for continuance for many producers once they have gotten over the initial hurdles of adoption and the producer becomes comfortable with all aspects of the practice. Continuation of the practice is further enhanced because of the capital commitments already made in implementing the practice, and because of potential future savings associated with the reduction in energy use from fewer trips across fields and reduced labor requirements associated with continuing the practice.
- 9) The CCX originally used a 30% discount from calculated actual reductions in determining the number of offset credits to issue but eventually concluded that 30% was too high. Some analysts believe that the discount percentage needed for the Permanence Reserve to work is in the 2% to 3% range. Annual USDA surveys of tillage practices to determine the levels of reversal activity on previously no-tilled lands would provide a good indicator of whether the Permanence Reserve provided by a 20% discount factor is too high or too low.
- 10) Approaching the permanence issue indirectly in a systemic way—rather than requiring permanence for individual contracts—is needed because of the structure of U.S. farming. Much land is rented out and farms are sold. Producers of particular tracts change over time. Dave Miller of the Iowa Farm Bureau, an expert on the CCX, notes that five-year contracts are about as far as contracts can be stretched and still get participation by farmers. “We need to trust the system to, on average, establish permanence for offsets. Without some approach like the CCX discounted credits and the ‘Permanence Reserve’ they create, a broader offset system for agriculture will never get off the ground.”

³ While there is a saturation point where no additional carbon can be sequestered so additional contracts would not work, the two following points indicate reasons why already sequestered carbon will not necessarily be released in large amounts—which is the condition that must be met for the CCX offset structure to be considered as providing permanent offsets.

⁴ Research by Drs. Alan Franzluebber, Jerry Hatfield, Charles Rice, etc.

- 11) All soil sequestration credits "share the burden" of potential loss of permanence. This method actively recognizes that there is a positive probability that some sequestration reversal activity could take place after the end date of the contract and that some portion of the sequestered carbon could be released to the atmosphere. However, it also recognizes that the exact timing, intensity and location of that reversal or carbon releasing activity is not known at the time of crediting for any soil sequestration activity, therefore all soil sequestration credits share the risk of a post-contract reversal by having a portion of their credits from current sequestration activities reduced by committing some pre-determined fraction of the actual sequestration rate to the implicit Permanence Reserve, thus reducing the actual amount of credits to that which now have the characteristics of "permanence". This approach removes the significant administrative burden of post-contract tracking of offsets and allows credited offsets to be fully fungible within the compliance regime. Post contract monitoring can be achieved by the survey methods previously listed and ongoing adjustments to the program and crediting rates, as appropriate.
- 12) Across a large landscape (such as production agriculture) the law of large numbers applies and the laws of probability apply. If all of the offsets from that class of offsets share the probability of loss of permanence and have that probability of loss quantified into the crediting rate, then the resulting "credited" offsets will only reflect the portion of offsets that are permanent.

Figure 1. U.S. Farmer and Landowner Participation in CCX Offset Programs
 9,008 producers enrolled, 16,632,284 acres, 37 States

| State | Number of Producers | Acres Enrolled | State | Number of Producers | Acres Enrolled |
|-------|---------------------|----------------|-------|---------------------|----------------|
| AL | 133 | 600,122 | MT | 484 | 1,701,004 |
| AR | 56 | 61,886 | NC | 10 | 4,000 |
| CO | 260 | 631,058 | ND | 1,381 | 1,804,845 |
| FL | 35 | 90,000 | NE | 1,553 | 3,754,961 |
| GA | 22 | 90,532 | NJ | 1 | 19 |
| IA | 671 | 386,534 | NM | 31 | 731,169 |
| ID | 8 | 40,846 | NY | 2 | 581 |
| IL | 942 | 200,443 | OH | 116 | 58,723 |
| IN | 133 | 94,947 | OK | 12 | 23,833 |
| KS | 402 | 505,790 | OR | 7 | 28,003 |
| KY | 133 | 75,580 | PA | 13 | 5,982 |
| LA | 42 | 32,858 | SC | 17 | 80,245 |
| MD | 10 | 5,155 | SD | 956 | 3,145,518 |
| MI | 395 | 186,016 | TN | 14 | 11,454 |
| MN | 247 | 70,899 | TX | 305 | 594,006 |
| MO | 92 | 45,663 | VA | 40 | 10,211 |
| MS | 182 | 50,337 | WA | 7 | 39,957 |
| MT | 484 | 1,701,004 | WI | 221 | 69,686 |
| | | | WY | 75 | 1,399,422 |

Figure 2. Emission Reductions and Project-based Offsets in CCX Years 2003 through 2007* (metric tons CO₂) – As of 02/20/2009 since a portion of new member emission reductions are currently undergoing verification.

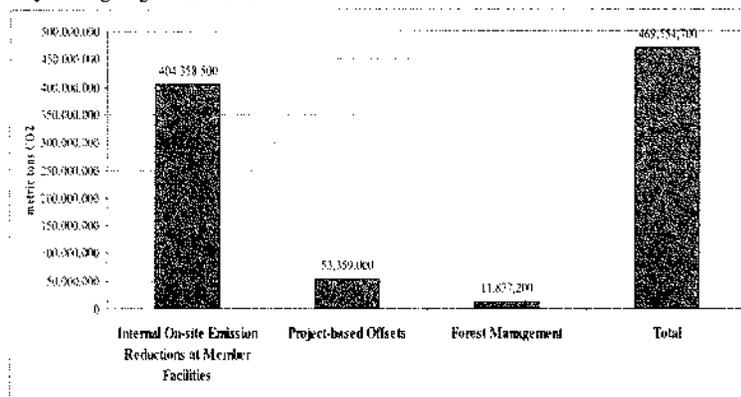


Figure 3. Chicago Climate Exchange Carbon Financial Instrument Spot and Derivatives volume 2004-2008

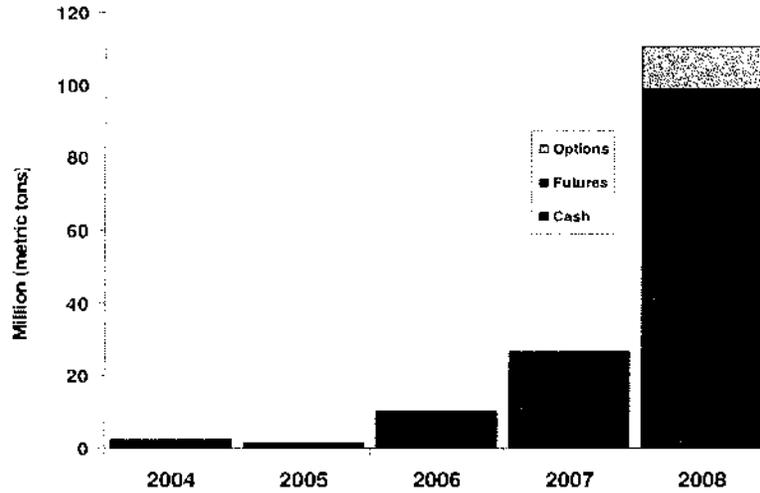
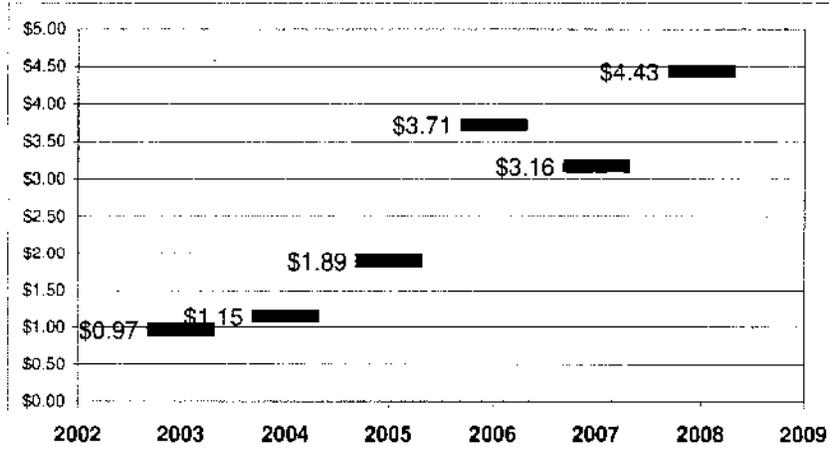


Figure 4. Annual Average* Price for CCX Carbon Financial Instruments 2003-2008



American Farm Bureau Federation policy on Carbon and Environmental Credit Incentives

We oppose the imposition of carbon emission related taxes or fees on horsepower of vehicles and equipment used for agricultural production.

We support research that identifies the advantages and disadvantages of carbon credits as it relates to carbon sequestration;

We oppose:

- (1) Mandatory air quality standards for ozone and particulate matter on farmers and agricultural businesses;
- (2) Air permits for agricultural operations that are not science based; and
- (3) Any efforts by the EPA to implement permitting fees and/or protocol or take regulatory action regarding greenhouse gas emissions for production agriculture.

Environmental Credit Incentives

Market-based incentives, such as pollutant credit trading, are preferable to government mandates.

We support:

- (1) The development of a practical voluntary market-based carbon credit trading system. To encourage this new market, we also support a USDA pilot carbon credit trading project to develop trading criteria, standards and guidelines;
- (2) Farmers being compensated for planting crops or farming practices that keep carbon in the soil;
- (3) Seeking alternative energy sources, which will minimize atmospheric pollution;
- (4) Providing incentives to industries seeking to become more energy efficient or reduce emissions of identifiable atmospheric pollution and the means of preventing it;
- (5) Providing incentives to individuals seeking to reforest fragile lands that are currently in agricultural production;
- (6) Emission offsets that sequester carbon through agricultural practices should be fully recognized in any cap and trade system and should not be limited to a percentage of total offsets;
- (7) Participation in climate discussions to enhance and maximize agriculture's ability to capture economic benefits from an emerging carbon market; and
- (8) Market-based solutions, rather than federal or state emission limits, being used to achieve a reduction in greenhouse gas (GHG) emissions from mobile sources.

We oppose:

- (1) Mandatory restrictions to achieve reduced agricultural greenhouse gas emissions;
- (2) Mandates relating to GHG policies, that would adversely impact agriculture;
- (3) Any attempt to regulate methane emissions from ruminant animals under the Clean Air Act or any other legislative vehicle;
- (4) Emission control rules for farming practices, farm equipment, cotton gins, grain handling facilities, etc., and urge EPA to re-evaluate the imposition of standards on farm and ranch equipment and other non-highway use machinery;
- (5) Unilateral mandatory state or federal GHG emission reduction requirements; and
- (6) Including the carbon impacts resulting from indirect land use changes in other countries in the carbon life cycle analysis of biofuels.

American Farm Bureau Federation Policy on Commodity Futures and Options

The integrity of all U.S. commodity futures and options exchanges as a pricing mechanism must be maintained by the members of the exchanges and their overseeing governing bodies. Commodity futures and options trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. Other commodities should be included where need exists and research shows futures and options trading would be beneficial. We urge that regulatory laws be strictly enforced. We support the use of off-exchange agricultural trade option contracts in commodity marketing, which would include complete risk disclosure, vendor integrity and the opportunity for cash settlement of the option. We should provide educational programs for producers to learn about this risk management tool and work with commodity buyers to offer agricultural trade option contracts.

We will:

- (1) Aggressively work to maintain agricultural representation on Commodity Futures Trading Commission (CFTC);
- (2) Oppose efforts by CFTC to regulate cash grain;
- (3) Encourage CFTC to require additional delivery points and assure an adequate delivery system;
- (4) Continue to work with state Farm Bureaus and their affiliated marketing agencies to encourage the expansion of forward pricing services based on futures and options and to strengthen current programs;
- (5) Encourage worldwide electronic trading at U.S. commodity exchanges;
- (6) Support expanded use of mini-futures contracts on all commodity exchanges;
- (7) Support changes in current futures contracts if research shows that they will result in maintaining or increasing liquidity of the market;
- (8) Oppose efforts to combine CFTC and the Securities Exchange Commission and support regulation of the commodity futures business by CFTC;
- (9) Urge CFTC to increase oversight of futures exchanges and floor traders to ensure that integrity of these markets is maintained and to curb practices that result in manipulation or artificial price swings;
- (10) Review price-setting mechanisms and make recommendations for the most effective price discovery systems for identity-preserved grains;
- (11) Urge the governing body of the commodity exchanges to continue to establish predetermined, publicized limits for margins at various market price levels for each commodity;
- (12) Oppose efforts by the commodity exchanges to charge a fee for delayed market quotes;
- (13) Conduct a review and actively participate in the reauthorization of the Commodities Exchange Act. That review will seek to minimize price manipulation and ensure the markets are effective as a price discovery mechanism given the increasing levels of contract production;
- (14) Encourage commodity exchanges to have an active and viable agriculture advisory committee; and
- (15) Support regular and thorough review of the CFTC and commodity markets.

We encourage the use of marketing tools or other marketing alternatives. We support hedge-to-arrive contracts being honored when used as a marketing tool that ensures delivery of the

commodity on the contract and has a set delivery date. Those entering into these agreement or contracts should be held liable for their own actions.



NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS
DUKE UNIVERSITY

TESTIMONY OF TIMOTHY H. PROFETA
DIRECTOR
NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS
DUKE UNIVERSITY
before the
U.S. SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY

September 9, 2009

Chairman Harkin, Senator Chambliss, and members of the committee, thank you for the opportunity to testify before the Committee today. It is an honor to be here.

Four years ago, I left Washington to found the Nicholas Institute for Environmental Policy Solutions at Duke University. The Institute is intended to be a two-way bridge between the knowledge and convening power of Duke and decision-makers such as yourselves. The Institute has focused its resources on the key environmental challenges facing our planet, and no topic has demanded greater attention than global climate change.

One area in which the Institute has recently focused is designing the financial market that would be created by a cap-and-trade system for greenhouse gases. It is clear that the success of this policy approach hinges, substantively and politically, on whether the market will operate in a way that is fair, efficient and responsive to the lessons learned from the current financial crisis. The Institute staff has worked with our Visiting Fellow Jon Anda to launch our Carbon Market Initiative, engaging with a number of faculty from Duke University's Fuqua School of Business and Law School to assess the key elements of a successful carbon market – from financial market design, to accounting, to auction design. Three papers are due to be published in October, led by Professors Vish Viswanathan, Leslie Marx and Katherine Schipper, that will more deeply investigate all of those topics.

The Benefits of a Market-Based Climate Policy

As I noted, this testimony is focused on the issues and concerns regarding the design of the greenhouse gas market. Given the financial market failures in recent years, it is understandable that a market approach should not be viewed as a foregone conclusion. However, I would submit that, given the Nicholas Institute's evaluation of the numerous policy options proposed to

address climate change, I believe the market approach remains an effective means to achieve the environmental goals of greenhouse gas emission reductions at the lowest cost.

Cost, in the end, is the determining factor. No sector of the economy is more attuned to these issues than the agricultural producers who are the constituents of this committee. As an aside, let me note that the Nicholas Institute this week released a report co-authored by several leading agricultural economists assessing the impact of a carbon market on farm incomes. The study found that net flow of GHG revenue and indirect commodity market revenues for farmers far outweigh increased operating costs. The study also forecast some losses in economic welfare to consumers and agricultural processors. However, benefits to crop and livestock producers far outweigh these economic losses, signaling gains to the sector as a whole. If done the right way, agriculture can be made a winner in climate legislation.

But no matter what the models show, no one would dispute that we should adopt the policy that achieves our goals at the lowest possible cost. History demonstrates that the market is the best means to accomplish this objective. In the most famous example, Congress mandated in the 1990 Clean Air Act that utilities engage in what was then called "emissions trading" to reduce sulfur dioxide pollution – a major contributor to acid rain. The 1990 Clean Air Act amendments, which launched the program, are a resounding success—achieving the environmental goals at 20 to 30 percent of the predicted cost.

Market-based systems to address environmental concerns allow both the federal government and private enterprise to take advantage of their respective strengths. The U.S. government is in the best position to set and enforce a "cap", or limit, on national GHG emissions. Capped entities determine for themselves the least-cost manner of complying with the emissions limits.

Under a cap-and-trade program, a GHG "allowance" is created for each ton of capped emissions. The allowances are fungible and can be traded among market participants. At the end of each compliance period, regulated firms surrender allowances to the government equivalent to their emissions. The program gives firms flexibility, either to reduce their own emissions or to buy allowances from another firm. This process minimizes the overall economic cost of the program, as it provides an incentive for firms with the lowest marginal cost of abatement to make the cheapest reductions first. Cap-and-trade systems are at the heart of the major legislative proposals to address climate change, including the American Clean Energy and Security Act passed by the U.S. House of Representatives earlier this year and the Climate Security Act that was before the Senate in June of 2008.

Without a market mechanism, the government must have perfect foresight of the costs of emission reductions and the circumstances that will affect those costs (such as when technologies will be available) in order to deploy resources most efficiently. Providing covered entities with flexibility in how they trade allowances among themselves may be especially important in this circumstance, as long-term compliance with the declining cap will depend on the emergence of new technologies.

Lessons Learned from Recent Market Failures

Much of the market's cost-reducing benefits, however, could be weakened if the market does not operate transparently and efficiently, thereby creating a sizeable gap between the price of greenhouse gas abatement and the price in the market. Americans know all too well that such imperfect markets occur, as the debate on climate change legislation takes place in the shadow of glaring examples of market failures over the past year and a half. These failures, however, can also provide important lessons that Congress can apply to the creation of a carbon market.

1. **Petroleum price spikes** – The spikes in the petroleum markets during the summer of 2008 highlight the importance of market transparency and adequate regulatory jurisdiction. No federal agency has comprehensive authority to regulate offshore petroleum markets and there was insufficient information to monitor potentially manipulative activity adequately. As a result, government officials and the general public were unable to determine the degree to which the price spikes were caused by excessive speculation, market manipulation, or normal market reactions to supply and demand. Recent regulatory changes give regulators this power, an important aspect of a successful regulatory process.
2. **Credit Default Swaps** – The economic crisis caused by failures of credit default swaps highlight the importance of a system for settling counterparty risk. In the CDS market, the settlement practice was inadequate, and the regulator was not aware of the vulnerable positions taken by major market players. The experience has underlined the need for transparency and adequate risk management. There is widespread acknowledgment that the CDS market would have benefited from (a) more government oversight to ensure the underlying value and integrity of the financial instruments and (b) more information to allow market participants to evaluate the risk of the parties with whom they were contracting.
3. **The Madoff Affair** – The Ponzi scheme orchestrated by Bernie Madoff highlights a separate issue—the importance of a vigilant regulator with adequate oversight authority and resources. In the Madoff situation, as the recent SEC inspector general's report indicates, the data needed to unearth the scheme were readily available; the cops were simply not walking the beat.

The lessons learned from these recent experiences are really quite clear, and if they are applied to the carbon market, should avoid repeats of the prior failures. In fact, the mechanisms to address these concerns already exist, and are included in many of the broader market reform proposals currently under consideration, including increased oversight, mandatory clearing of standardized products, real-time pricing and volume transparency, and expanded agency jurisdiction to cover the full scope of activity in a marketplace. These reforms, if passed by Congress, may apply across U.S. financial markets, including a new carbon market.

Unique Aspects of the U.S. Carbon Market

Many will claim that the carbon market should be treated just like any other commodity market. But it would not be like any other market – it will be somewhat unique. There are three distinguishing aspects of the market.

First, unlike markets in physical commodities, the entire carbon market system is created by the government to achieve a societal goal. Demand for the product, and the product itself, is created by government action, and thus the government has a special duty to ensure that its market operates effectively. Confidence in the product is also essential; in this way, the government's role in providing an accurate and transparent registry of emissions and in creating the protocols to ensure that offsets are real and verified are essential to keeping confidence in the market.

Second, entities covered by the legislation will have no choice but to participate in the market, and it is a market with an ever-reducing supply. For example, if the American Clean Energy and Security Act became the law of the land, a pool of 5.5 billion allowances in 2016 would decline to 5.1 billion in 2020 and 3.5 billion in 2030. Unlike traditional commodity markets, options for increasing supply in the event of allowance shortages will be limited to the amount of credits allowed from offset projects that operate outside of the covered sectors.

Third, the carbon market is likely to be driven heavily by derivative instruments (i.e., futures and options), underscoring the need to design an appropriate regulatory structure from the outset. Legislation will likely result in the existence of two major markets: (1) a cash market that will trade allowances from the current year; and (2) a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances.

Because of the design of climate legislation, the derivatives market will likely dominate. In particular, climate legislation will likely create a long-term obligation for regulated entities and those entities will need access to financial instruments to hedge their exposure—a necessary element to securing investment for new, low emitting energy technologies. The American Clean Energy and Security Act, for example, would distribute 132 billion allowances from 2012 through 2050. Yet, less than 5 million allowances will be issued in the first year of the program. This small initial “float” of allowances will likely drive demand for derivatives that offer future protection against price changes. Looked at another way, we are asking emitters to take on 38 years of abatement with potentially as little as 1 year of allowances available to manage risk.

From that perspective, it is entirely appropriate that we are here today, as the Commodities Futures Trading Commission is the natural entity to regulate the derivatives market expected to arise under these circumstances. Effective regulation of these markets is critical to ensuring a stable market that provides covered entities with the financial products necessary to meet their compliance obligations in an efficient manner.

At bottom, we must develop this market *de novo*. Financial markets typically evolve over time as they grow, and regulatory changes often follow the development of new financial products or respond to failures in the market system. Because Congress would create a new carbon market via legislation, lawmakers have the opportunity to design a transparent, efficient market at the

outset that builds on the best practices for market regulation and lessons learned from recent market failures.

Four Principles for the Carbon Market

I would like to leave you with four principles for an effective carbon market based on the lessons of the past decade: (1) real-time transparency; (2) adequate risk management and settlement; (3) a vigilant and well-funded regulator; and (4) transparent data and strong quality controls on the allowances traded.

1. Real-Time Transparency

Electronic markets for stocks and bonds have demonstrated that real-time transparency has made markets more efficient. Electronic markets also facilitate real-time market oversight – making it better, faster, and cheaper. Real-time access to information about market activity is the cornerstone to managing risk, reducing market volatility, and empowering market participants and watchdog organizations to monitor the market for manipulation, excessive speculation, and other illegal activity. Accurate, real-time information about prices and trade volume allows market participants to make more accurate bids and offers. This, in turn, helps to ensure that allowance prices more accurately reflect the marginal cost of abating emissions.

Transparency also can help maintain public confidence in the fairness and stability of the market—an element that may be essential to the long-term success of the cap-and-trade program’s ability to reduce emissions in a cost effective manner. Real-time market information allows the public to monitor the effectiveness of the regulator as well as the behavior of market participants. Market data collected from multiple sources could also help assure public investors that their assessments of price, market direction, and counter-party risk are based on accurate data. In addition, disclosure requirements for publicly-held companies and financial institutions allow investors to verify the accuracy of financial reports.

In general, publicly-available information should include:

- The instruments that are trading;
- Prices;
- The volume of trading activity;
- Where trading is taking place
- The entities that are trading and the positions they hold; and
- The positions held by market participants.

To the extent that carbon instruments are traded on registered exchanges, the exchange member’s activity will be “printed” on the exchange as the trade occurs. This would apply to allowances, futures, options, and possibly swaps. If OTC transactions take place in the carbon market, the legislation will need to ensure that the regulator, market participants, and the general public have sufficient data to oversee and evaluate trading activity.

Congress will need to balance the public's access to timely market information with the legitimate concern that covered entities may need to protect confidential business information. It is important to note that the default real-time transparency as to "who" is trading is limited to the registered exchange member. In some cases this may be an emitter, but in many cases it will be an intermediary. Emitters, just like large mutual funds in the equity markets, could report their positions at a later date so that their activity cannot be "front-run" by others. Emitter reporting could be monthly or even quarterly along with their financials.

In addition to the information made available to the general public, regulators should have access to the full range of market activity in real-time in order to prevent and punish market abuses, including fraud and manipulation. The more detailed information an oversight body receives concerning trade prices, volume, positions, and trends, the better its capacity to detect trading irregularities and inconsistencies. With each of these elements in place, regulators can respond quickly to unexplained spikes in market price or trade volume to abate excessive speculation and ensure that prices reflect supply and demand.

2. Adequate Risk Management and Settlement

Carbon market participants also need to know that allowances purchased on the spot, forward and futures markets, which are held to maturity, will be delivered. The collapse of the mortgage-backed securities and credit default swaps markets in the fall of 2008 highlights the importance of managing the levels of risk that market participants may undertake.

In regulated financial markets, counterparty risk is generally managed by "clearing" transactions. Clearing consists of the confirmation, settlement, and delivery of transactions. Clearing houses serve as a central counterparty in a transaction in order to protect opposing parties from a default by the other. Clearing houses also compute the adjusted value of open positions on futures contracts (how much is owed or collectible) based on changes in contract prices – and use this information to adjust margin to ensure integrity on the marketplace. In addition, the clearing organization may verify the transactions between parties to discover and resolve any discrepancies quickly.

In the carbon market, a capped entity cannot run the risk that a contract to purchase allowances will not be fulfilled. This is the element of a compliance market that differs from a financial market. One can imagine financial remedies for non-performance of a carbon allowance contract. However, the capped entity that has not had its purchase filled with a physical delivery cannot submit to the EPA a financial settlement—it must submit allowances. Monitoring of the spot, futures and forward markets to assure that market participants are able to make delivery on their contractual agreements will be an important part of the regulators role in the carbon markets.

As much trading should occur on exchanges, or at least be cleared centrally, as is feasible. The system that you are building for this market really has three goals: (1) price discovery, (2) transparency, and (3) risk management through clearing. An exchange requirement would achieve all three goals; a requirement to print and clear all trades, even those occurring over the counter, will achieve the latter two. And in fact, as long as some significant volume occurs

across the exchanges, there will be discovery of prices that can be used to inform the OTC transactions as well.

Many will contend that clearing of long-term structural contracts will be difficult, as such transactions are unique and not liquid, and that parties will be required to post the collateral, or margin, necessary to participate in the market. These are nontrivial issues, and pose a choice between mitigating systemic risk and creating the additional cost of posting margin for entities. It will be your role to evaluate the tradeoff between these priorities.

In the case that Congress provides any exceptions to cleared or exchange-traded transactions, transparency for the counterparties and the regulator is even more essential so that the counterparty risk can be effectively evaluated.¹ Such exceptions should only occur if regulators know the extent of the obligations of the various counterparties in the carbon allowance and allowance derivative markets so as to ensure that such OTC markets remain properly regulated.

3. Vigilant and Well-Funded Regulator

Access to market data should be coupled with sufficient resources to process and analyze the information, broad jurisdiction that allows the regulator to oversee any trading that involves allowance-based financial instruments, and appropriate enforcement to address market abuses when and where they may occur. If Congress will ask the CFTC to take on the oversight of this new market with the degree of detail that is suggested here or in the current proposal from Senators Feinstein and Snowe, then more resources will be required to build the team of regulators needed. Some would fund this through a fee applied to trades. I would suggest that another alternative exists in tapping the value from auctioned allowances. Either way, the legislation has the means to create the funds needed.

With respect to the regulator's vigilance, it is a challenge that this Committee can uniquely answer. Tight Congressional oversight will help ensure that the "cops remain on the beat." And some forethought might further benefit that oversight, as the Committee might ask for data about the market to be provided regularly so that it too can monitor the market.

4. Transparent data and strong quality controls

Finally, the government must ensure that the information regarding the allowances traded in the market is transparent, predictable and reliable. Information, in the end, is what enables you to turn emissions into a tradable item. It gives the market apples-to-apples confidence in the products, particularly since greenhouse gas emissions are not as tangible a commodity as oil or pork bellies.

¹ What exceptions should there be for non-standard instruments to be transacted OTC? One suggestion developed by Professor Vish Viswanathan at Fuqua School of Business and that will be published in his October paper is to use the post-trade reporting of non-standard instruments to determine when volume is sufficient to require the contract to be "printed and cleared" on an exchange. For example, if there was a large volume of swaps for, say, carbon versus Libor, then such contracts could be required to move to listed trading.

First, the government must regularly and predictably produce information about the nation's emissions to allow for the market to evaluate demand. A good example of an effective program in this regard is the U.S. Acid Rain cap-and-trade program administered by the EPA. That program focuses the majority of its enforcement efforts on the accurate tracking of emissions and allowances. EPA handles vast amounts of information; it processes information for compliance purposes and makes emission and allowance data accessible to facilitate an efficient allowance market which builds public credibility in the emissions trading program. The key is that the ARP relies on a common measurement metric through rigorous continuous emissions monitoring systems (CEMS) with quarterly reporting of hourly emissions.

An example of how the poor provision of government data temporarily undermined a market can be found in the European Union. In the E.U. Emissions Trading System, most emissions were not measured directly; they were determined by calculation based on fuel consumption, specified emission factors and the thermal efficiencies for combustion units and on output and other chemical and engineering estimates for process emissions. During the 3 year experimental phase in the EU ETS (2005-2007) a significant price decline occurred in April 2006 following the reporting of 2005 emissions data by several member states in amounts that were significantly less than expected.

The government also must provide the market with adequate assurances that the products traded in the carbon market are what they claim to be. With regard to the emissions allowances, this is simple and straightforward. The government will create, serialize and track the government-issued right to emit.

With regard to offset credits, however, the government's role is to provide adequate protocols and procedures to ensure the market that any carbon offset project is real and verified. In particular, for offsets markets to be successful and to contribute to emission mitigation goals, there must be confidence that offset reductions do in fact occur, that they can be properly quantified, that they are additional to what would have occurred without the project, and that any re-emission later (reversal) or induced uncontrolled emissions in other locations (leakage) are properly accounted. In doing so, the government must balance the need to provide quality assurance with the need to keep the costs of verification and monitoring low enough to attract investment in the projects.

Fortunately, I believe such a balance can be struck. In our work at the Nicholas Institute, we have engaged with producer groups, market participants, environmental advocates, and emitters to design policy that can provide environmentally valuable offsets at lower transaction costs. These efforts, first published in our report *Designing Offsets Policy for the U.S.*, continue as we strive to find the correct balance.

I also now serve on the board of the Climate Action Reserve, a national organization focused on providing regulatory-quality standardized protocols for the development, quantification and verification of greenhouse gas emissions reduction projects in North America: issuing carbon offset credits known as Climate Reserve Tonnes (CRT) generated from such projects; and tracking the transaction of credits over time in a transparent, publicly-accessible system. For the project types already approved by the Climate Action Reserve, I believe that the protocols have

struck this balance, for at least some project types, as evidenced by the strong investor interest in offsets projects using their program.

One final note – Accounting

While time does not permit a fulsome discussion of this issue, I would like to draw your attention to a short line in the U.S. Climate Action Partnership blueprint highlighting the need for “rational accounting” If a utility needs a futures contract as a bridge to a new low-carbon power plant – and their intention is to take delivery of the allowance at expiration to submit for compliance – should that utility have to mark the contract to market each quarter? Such a requirement should not be imposed lightly, since doing so would only encourage OTC hedging, or less risk management overall.

Conclusion

The market is very powerful tool, by which environmental objectives may be achieved at historically low costs. But the market also can fail, particularly if it does not have adequate provisions to ensure that transactions are fair and transparent. As I have testified, I believe the mechanisms exist to avoid such a failure.

Concerns about market abuses have nonetheless led some to conclude that now is not the time to create a new market. Let me posit that the exact opposite is true. If you choose to create a market, now is the best time to create a transparent, effective market that prevents excessive speculation and manipulation while allowing individual business leaders the flexibility to decide how to comply. The lessons from past market failures are fresh in our minds, and the public is attuned to the needs. If it wants to do so, Congress has all the tools it needs to create a well-functioning marketplace.

REFERENCES

- Testimony of Jon A. Anda before the Subcommittee on Energy and the Environment, House Energy and Commerce Committee, April 24, 2009, available at http://energycommerce.house.gov/Press_111/20090424/testimony_anda.pdf
- Justin Baker, et al., *The Effects of Low-Carbon Policies on Net Farm Income*, Nicholas Institute Paper NI WP 09-04 (2009)
- Denny A. Ellerman and Paul L. Joskow, "The European Union's Emissions Trading System in Perspective", Pew Center on Global Climate Change (2008).
- Richard F. Kosobud, Douglas L. Schreder, Holly M. Biggs, *Emissions trading: environmental policy's new approach* (2000).
- Jonas Monast, Jon Anda, and Tim Profeta, *U.S. Carbon Market Design: Regulating Emission Allowances as Financial Instruments*, Nicholas Institute Paper CCPP 09-01 (2009)
- Lydia Olander, *Designing Offsets Policy for the U.S.*, Nicholas Institute Paper NI R 08-01 (2008).
- Testimony of Jon A. Anda before the Subcommittee on Energy and the Environment, House Energy and Commerce Committee, April 24, 2009, available at http://energycommerce.house.gov/Press_111/20090424/testimony_anda.pdf
- Various Authors, *Mitigation Beyond The Cap: A Series of Briefs on Expanding Climate Mitigation Opportunities*, Nicholas Institute Policy Briefs, 08-01A, 08-01B, 08-01C, 09-03 (2008 and 2009)

**Testimony of the
USA Rice Federation
and the
US Rice Producers Association**

**Before the U.S. Senate
Committee on Agriculture, Nutrition, and Forestry**

**To Review Global Warming Legislation: Carbon
Markets and Producer Groups**

September 9, 2009

Introduction

Chairman Harkin, Senator Chambliss, and members of the Committee, thank you for holding this hearing on climate change legislation and carbon market issues. We appreciate the opportunity to offer testimony before the Committee on Agriculture, Nutrition, and Forestry concerning rice industry views on climate change legislation.

My name is Frank Rehermann and I offer this testimony on behalf of the USA Rice Federation. I currently serve as chairman of the USA Rice Producers' Group and vice chairman of the USA Rice Federation and am a rice farmer from Live Oak, California. My wife and I operate our farm as a family partnership growing 800 acres of rice in the Sacramento Valley. I have been farming since 1972.

U.S. Rice Industry Overview

The USA Rice Federation is the global advocate for all segments of the United States rice industry with a mission to promote and protect the interests of rice producers, millers, merchants, and other allied businesses that comprise much of the multibillion dollar U.S. rice industry. The US Rice Producers Association represents rice producers in all 6 of our major rice producing states. Together, USA Rice and the US Rice Producers Association represent virtually the entirety of the U.S. rice industry – from farmers to processors to marketers to exporters. The rice industry provides jobs and income for not only producers and processors of rice, but for all of these parties in the value chain.

Rice is planted on about 3 million acres in six states, including Arkansas, California, Louisiana, Mississippi, Missouri, and Texas. The U.S. rice industry is unique in its ability to produce all types of rice, from long grain, medium grain, and short grain, to aromatic and specialty varieties. Last year, U.S. farmers produced a rice crop of nearly \$3.4 billion in farm gate value.

Today, about 81 percent of all the rice that is consumed in the U.S. is produced here at home. And, despite U.S. and foreign trade barriers to U.S. rice exports, the U.S. remains the largest non-Asian exporter of rice and the third largest exporter worldwide. On average, between 40 to 50 percent of the U.S. annual crop is exported as either rough or milled rice.

The United States' top export markets for rice include Mexico, Japan, Iraq, Haiti, Canada, and most of Central America. In 2008 we exported over \$2.2 billion in rice to markets around the world.

Americans consume 25 pounds of rice per person per year. Of the rice produced by our farmers that remains in the domestic market, 53% is bound for direct human food use and 16% dedicated to processed foods, 15% for beer, 14% for pet food, and the remaining for industrial uses.

The 2005 Dietary Guidelines and MyPyramid recommendation, published jointly by the Departments of Agriculture and Health and Human Services, call for 5 to 10 servings of grains daily, with half the servings coming from whole grains, such as brown rice, and 45 to 65 percent of calories coming from complex carbohydrates, such as rice. Rice is a wholesome source of nutrition, with no sodium, no cholesterol, no glutens, and no trans or saturated fats.

Beyond the substantial economic and nutrition benefits of rice is the environmental dividend from winter-flooded rice fields that provide critical habitat for migratory waterfowl and other wetland-dependant species. All the major rice-production areas in the U.S. correspond with important areas of waterfowl activity during winter months. Rice-growing areas provide surrogate habitats for hundreds of wildlife species that rely on wetland conditions for species survival, some of which are currently or could be threatened if not for the wetland environments provided by flooded rice fields. Without rice farming, wetland habitats in the U.S. would be vastly reduced. A loss of this magnitude would have a disastrous effect on waterfowl, shore birds, and a host of other wetland-dependant species.

Rice Industry Concerns with Climate Change

The climate change legislation pending before Congress is not supported by the U.S. rice industry. With respect to the American Clean Energy and Security Act (H.R. 2454) that narrowly passed the U.S. House of Representatives earlier this summer, we supported the efforts of House Agriculture Committee Chairman Collin C. Peterson and other Members of the House who worked to mitigate the bill's adverse impacts on agriculture. But neither of our organizations supported passage of the bill as amended.

Unfortunately, despite these efforts, the costs of this legislation still heavily outweigh any potential benefits, leaving us no choice but to strongly oppose the legislation. Simply put, at a time when America's rice farmers are already facing significant production costs and are forced to compete on an uneven global playing field, climate change legislation would add insult to injury.

One of the key areas of focus in our analysis of the legislation has been the impact on rice production costs as a result of higher costs for major inputs such as fuel, electricity, fertilizer, natural gas, and propane. Rice is flood irrigated, requiring energy to pump either ground or surface water. In addition, rice is a high yielding crop utilizing nitrogen fertilizer which, in turn, is made using natural gas. Furthermore, all rice must be dried before it can be stored. Finally, beyond the increased costs of field production, U.S. rice must also be milled before it can be consumed or utilized in products. All of these already significant costs are expected to substantially increase, both in the short and long term, under climate change legislation and this does not take into account increased transportation costs and other costs due to rise as a result of this legislation.

Increased input costs will make us less competitive vis-à-vis our major global competitors, such as Vietnam, Thailand, Pakistan, and India, who already benefit from heavy government involvement in their rice production. Congress should not approve legislation that will have the effect of shifting rice production overseas to foreign competitors that are made the lower cost producer solely because of the policies of our own government. Such a move would result in the loss of thousands of American jobs in the rural areas of the Mississippi Delta, the Louisiana and Texas Gulf Coast, and the Sacramento Valley of California. These areas rely, to a large extent, on the U.S. rice industry to support their local economies and jobs. Shifting our agriculture production overseas and becoming dependant on other countries for food production will only threaten our nation's food security.

Regarding the role that U.S. agriculture can play in reducing greenhouse gas emissions, while, in the net aggregate, U.S. agriculture sequesters more greenhouse gases than it emits, there are currently few, if any, opportunities for rice production to further sequester or reduce greenhouse gases.

That is not to say that due diligence is not being done to investigate ways in which rice might meaningfully contribute to greenhouse gas sequestration or reduction in the future. In fact, work is currently underway in California to develop computer-modeling techniques to quantify greenhouse gas emissions. Once complete, this model will also predict the greenhouse emissions response to certain changes in cultural practices. Current pilot-scale activities are being implemented to evaluate potentially beneficial activities. Both implementation challenges and impacts on yield and production costs will be evaluated to see if any ideas are ultimately deemed feasible.

If efforts in California are successful, greenhouse gas sequestration and reduction would be added to the long list of contributions to conservation already provided by rice producers including the provision of wetlands for hundreds of wildlife species as well as migratory birds in the Mississippi, Central, and Pacific flyways. We are simply not there yet on sequestration.

So, we are confronted with no economic upside under pending climate change legislation and plenty of economic downside. For instance, a recent analysis by the Agricultural and Food Policy Center at Texas A&M University estimates that due to the increase in input costs for rice and the likelihood of no opportunity to participate in an offset credit program at this time, all 14 representative rice farms analyzed would experience lower average annual net cash farm income ranging from \$30,000 to \$170,000 in reductions per operation. Annual costs for these farms increase from \$20,000 to \$120,000 during the 2010 to 2016 period. And while the commodity price is expected to increase slightly it is not enough to make up for the significant cost increases. The American Farm Bureau Federation also estimates that the *increase* in rice production costs per acre could reach as high as \$153.00. That's not the difference between a large profit and a lean profit. That's the difference between break even and broke.

At a time when U.S. farm income is already projected to be down 38% from last year and given the condition of the U.S. economy overall, we are deeply concerned about where this legislation would position us in the global economy, particularly since it is highly unlikely that our key global competitors will impose an equally rigorous regulatory regime on their own industries if our past trade agreements are any indication. In fact, recent reports that some in the developing world are calling on developed nations to make sharp reductions in greenhouse gas emissions while insisting that they not be bound to any specific level of reductions is ominously familiar to those of us closely observing WTO Doha Round discussions.

As such, we would strongly urge the Members of this Committee to fully evaluate alternative approaches to curbing greenhouse gas emissions and to oppose pending or similar climate change legislation. In this vein, we wish to express our gratitude to the Members of this Committee who have urged that the cap and trade provisions of climate change legislation be dropped entirely. To be sure, there are ways to reduce greenhouse gas emissions and reduce our dependence on oil-exporting countries without crippling the U.S. economy. Focusing on energy

efficiency measures and additional renewable and clean energy development are just a few of these avenues.

Recommendations to Improve Climate Change Legislation

If, however, pending or similar climate change legislation is ultimately considered in the Senate, we believe there are several key provisions that must be clearly and explicitly included in the bill to help ensure U.S. agriculture is not irreparably injured in the process. These key provisions include:

- An express exemption should be provided for the agriculture sector from the greenhouse gas emission reduction requirements of the climate change legislation and the underlying Clean Air Act.
- The definition of "agriculture sector" for purposes of this exemption should be clarified to include production through the stage of processing ordinarily necessary for the commodity to be widely marketed in commercial channels.
- Increased funding should be provided for research programs and activities by USDA and the land grant university system to develop improved production and management practices and technologies to help agriculture sequester greenhouse gas emissions, with a particular focus on research for those crops that currently have little or no opportunity in this regard.
- Establishment of a program using the funds and authorities of the Commodity Credit Corporation to compensate producers for increased input costs.
- Establishment of a robust agricultural offset program that is flexible and run entirely by USDA, not the EPA.

Conclusion

In conclusion, on behalf of the U.S. rice industry, I strongly urge this Committee to work with the Senate leadership to postpone consideration of climate change legislation until such time that alternative legislative approaches to curbing greenhouse gas emissions are developed which do not injure American agriculture or the U.S. economy, generally. If this effort is unsuccessful, then we respectfully request that this Committee work with the other committees of jurisdiction and your Senate colleagues to ensure that the provisions provided above are included in any climate change legislation that is enacted into law. We believe that, without these provisions, the current approach to climate change would be catastrophic to American agriculture.

Thank you for the opportunity to provide our views. I would be happy to respond any questions.

**Statement of
Julie Winkler,
Member of the Board of Directors, Green Exchange Venture
Before the
Senate Committee on Agriculture, Nutrition and Forestry
Hearing on Regulating Carbon Markets
in a Cap-and-Trade System**

September 9, 2009

I am Julie Winkler, Managing Director of Research and Product Development of CME Group Inc. ("CME Group") and Member of the Board of Directors of the Green Exchange LLC. The Green Exchange Venture appreciates the opportunity to provide its views to the Senate Committee on Agriculture, Nutrition and Forestry regarding the design and regulation of a U.S. carbon market.

We believe that cap-and-trade is the preferred solution for guaranteeing emissions reductions at the lowest possible cost to the economy. We strongly support providing compliance entities with a choice of utilizing exchange traded derivatives and over-the-counter ("OTC") instruments with additional transparency to meet their environmental obligations. Also to provide these customers with effective risk management tools and liquidity, the U.S. carbon markets must allow for broad market participation. We believe that the Commodity Futures Trading Commission ("CFTC") is best suited as the regulator of the U.S. carbon market and they will ensure a transparent and effectively regulated carbon market. Lastly, to ensure the use of transparent markets and central clearing services and the necessary liquidity and price discovery they provide, regulatory proposals should not include a transaction tax on carbon derivative exchanges.

Green Exchange Venture

CME Group is a founding member of the Green Exchange Venture along with Evolution Markets, Credit Suisse, Goldman Sachs, JP Morgan, and Morgan Stanley. The founding members are joined by partner firms from across the energy, environment, and financial sectors: Constellation Energy, ICAP, RNK Capital LLC, Spectron, TFS, Tudor Investment Corp. CME Group currently provides the electronic trading platform, Central Counterparty Clearinghouse ("CCP") services, market data distribution, and regulatory services to the Green Exchange Venture. CME Group is the world's largest and most diverse derivatives marketplace and through its subsidiaries operates four separate Exchanges: Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City

of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX").¹

CME also operates CME Clearing, one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for OTC derivatives contracts through CME ClearPort®. CME ClearPort provides clearing services to eligible participants, mitigates counterparty risk and brings OTC transactions within the regulatory oversight of the CFTC.

While the Green Exchange Venture was formally launched as a standalone entity this year, CME Group and the other Green Exchange Venture partners bring more than a century of experience in building markets to meet the risk management needs of commercial and financial participants.² The Green Exchange Venture member firms have been actively involved in designing and participating in all major environmental markets around the world, including U.S. emissions cap-and-trade programs for sulfur dioxide ("SO₂") and nitrogen oxide ("NO_x"), the global renewable energy trading markets, the European Union ("EU") Emissions Trading System ("ETS"), and the global carbon offset market.

Following CFTC review and approval of our application for contract market designation³, the Green Exchange product slate will include futures and options on European Union Allowances ("EUA"), Certified Emission Reductions, SO₂ Allowances, NO_x Allowances, and Northeastern Regional Greenhouse Gas Initiative Allowances (RGGI). These environmental contracts are highly flexible financial instruments useful to qualified market participants to meet their risk management needs. As an example, our EUA futures contract represents one-thousand EUA allowances, equaling one ton of emissions. Our product slate will also be expanded to include derivatives based on a U.S. cap-and-trade program if such legislation is approved. Until the contract market designation is obtained by Green Exchange, environmental futures and options products are trading on the NYMEX through the CME Globex® electronic trading platform and listed for clearing on CME ClearPort.

¹ The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

² The CBOT became involved in the U.S. emissions market in 1993 when it was chosen by the Environmental Protection Agency (EPA) to administer the SO₂ auctions. After an objective selection process, the CBOT was chosen to run the auctions because of its demonstrated ability in handling and processing financial instruments and using transactional information systems. The CBOT was not compensated for these services by EPA and administered this innovative auction in partnership with the EPA for 12 years.

³ Upon approval as a Designated Contract Market (DCM), the Green Exchange Venture will become a self-regulatory organization (SRO) with frontline market and trade practice surveillance responsibilities, subject to oversight by the CFTC. As an SRO, the Green Exchange Venture will be required to adopt and enforce rules to effectuate 18 core principles. It will be required to monitor trading activity, enforce rules, take appropriate disciplinary action, monitor deliverable supplies, detect and deter manipulation, among other things to ensure the integrity of the markets.

Lastly, we are actively engaged in discussing the U.S. climate policy; the CME Group was recently invited to join the Pew Center on Global Climate Change's Business and Environmental Leadership Council -- a partnership of 45 companies including Fortune 500 energy, manufacturing, and other companies. We believe that our insights from other markets and our understanding of the policy debate surrounding the creation and oversight of environmental markets, provides a crucial perspective on the carbon market policy discussion.

Reducing Emissions through a Cap-and-Trade System

Scientists believe that climate change is a global threat that requires a response to bring about substantial reductions in carbon dioxide and other greenhouse gas ("GHG") emissions. According to the 2007 Intergovernmental Panel on Climate Change ("IPCC") report, the global average temperature could rise by 2.4-6.4°C by the end of this century if no corrective action is taken.⁴ This would lead to serious consequences from both an environmental and economic perspective for developed and developing countries.

A market-based solution, such as a cap-and-trade program, offers the best opportunity to minimize the cost of mandatory reductions in GHG emissions. The U.S. Climate Action Partnership ("USCAP"), an alliance of major businesses and leading climate and environmental groups, has stated that "cap-and-trade is essential" and "allows the economy-wide emission reduction target to be achieved at the lowest possible cost."⁵ In a cap-and-trade system, one allowance would be created for each ton of GHG emissions allowed under the declining economy-wide emission reduction targets (the "cap"). Those emitters who can reduce their emissions at the lowest cost would have to buy fewer allowances and may have extra allowances to sell to remaining emitters for whom purchasing allowances is their most cost-effective way of meeting their compliance obligation. Like USCAP, leading environmental and nature resource groups such as the Natural Resource Defense Council, Environmental Defense Fund and the Pew Center on Global Climate Change are supporting U.S. cap-and-trade.⁶ Additionally, agriculture organizations such as National Farmers Union also view cap-and-trade as the preferred approach for reducing emissions.⁷

Cap-and-trade in the U.S. is not a new mechanism as the U.S. was the global leader in utilizing a market-based solution to establish the Acid Rain Program under the 1990 U.S. Clean Air Act Amendments. The SO₂ trading system has been regarded as an innovative solution, which is achieving its stated goals of reducing overall atmospheric

⁴ IPCC. "Climate Change 2007: Synthesis Report." Published by the IPCC on Climate Change. 2008.

⁵ USCAP. "A Call to Action. Consensus Principles and Recommendations from USCAP: A Business and NGO Partnership." 2009.

⁶ Environmental Defense Fund. "The Case for Cap-and-Trade." July 23, 2009.

⁷ Testimony of Roger Johnson, President, National Farmers Union. "Concerning the Role of Agriculture and Forestry in Global Warming Legislation" before the Senate Committee on Agriculture, Nutrition and Forestry on July 22, 2009.

levels of SO₂ and NO_x.⁸ The EPA also estimates that by 2010, the overall compliance costs to businesses and consumers will be \$1-2bn per year, one quarter of the original one quarter of the originally predicted cost.⁹

In January 2009, ten Northeastern and Mid-Atlantic States launched the first mandatory, market-based effort in the United States to reduce GHG emissions called the Regional Greenhouse Gas Initiative (RGGI). This program aims to reduce capped CO₂ emissions from the power sector and will require a 10 percent reduction in these emissions by 2018. Alongside the allowances and offsets trading in the RGGI program, there are both derivative and OTC contracts being traded by market participants.

In the EU, the ETS is the largest cap-and-trade program in the world currently covering more than 12,000 installations in the energy and industrial sectors, which account for approximately 40% of the EU's emissions of CO₂ and other GHGs. Since 2005 when the first trading period for ETS began, transaction volumes have grown by almost ten times.¹⁰ With respect to carbon emissions, initial evidence from the EU ETS demonstrates that leading companies subject to the caps are utilizing the carbon markets to effectively reduce emissions. According to a July 2009 Global Carbon Trading Study, it is estimated that global carbon trading could reduce the cost of emissions reductions by up to 70% in 2020 compared to a carbon cap without a trading component.¹¹

Cap-and-trade programs are proving that they can successfully cut emissions with efficiency and cost effectiveness. Emissions trading systems are already operating or planned in over 35 countries in the developed world.¹² Clearly, the global carbon trading is expanding rapidly and the U.S. would not want to miss the opportunity to play a defining role in this market's growth.

Cap-and-Trade Design Features

There are several design features that are critical to a well-functioning cap-and-trade system such as establishing an accurate emissions baseline, determining how allowances are to be auctioned or distributed, and collecting and disseminating market data. Based on our extensive market development experience, the Green Exchange Venture partners also strongly believe that a cap-and-trade system must include broad market participation and not be constrained by artificially created carbon price constraints.

⁸ Between 1990 and 2007, SO₂ emissions decreased by 43% and the 2010 emissions target was reached three years early.

⁹ Ellerman, A. Denny and Paul L. Joskow. "The European Union's Emissions Trading System in Perspective." Prepared for the Pew Center on Global Climate Change. May 2008.

¹⁰ Ellerman, A. Denny and Paul L. Joskow. "The European Union's Emissions Trading System in Perspective." Prepared for the Pew Center on Global Climate Change. May 2008.

¹¹ Lazarowicz, Mark. "Global Carbon Trading – A Framework for Reducing Emissions." Prepared for the United Kingdom Prime Minister. July 2009.

¹² Current ETSs in production and under development in other countries plan to result in 17-35% reductions in global emissions being covered under these programs by 2015.

For a cap-and-trade system to work effectively, the carbon market must have participation beyond compliance entities. A market that includes liquidity providers such as financial intermediaries and offset aggregators from the onset will ensure that buying and selling occurs on a routine basis as various market participants express different views on the market. These types of participants also provide essential market services to their clients, compliance entities, by assisting in managing price risk, providing financing for emissions reduction activities, and in general engaging in large-scale capital deployment which can reduce compliance costs.

Government imposed price floors or ceilings should be avoided if a carbon market is to play its role in creating meaningful price discovery. Price caps reflect factors extraneous to the fundamental factors that drive prices, and thus are not connected to actual supply and demand. While it may seem that artificially constraining prices with a ceiling will reduce price volatility or market manipulation, the opposite is likely to result. With a ceiling derived from non-market based factors lying idle above a market price, the free flow of buying and selling can be overshadowed by the knowledge that there is a flood of allowances to be unleashed at the ceiling price. The reverse could take place at price levels close to a floor, where demand automatically and arbitrarily surges.

A price cap would not only interfere with the generation of a meaningful market price for carbon, it would also discourage low-carbon energy and agricultural offset investors from participation in the market since they would be unable to benefit from increased prices for offset credits. Lastly, a price cap would interfere with the maturing of a global carbon market since if implemented in one jurisdiction and not others, it will distort pricing relationships.

We fully understand the motivation to protect American consumers from dramatic increases in the cost of carbon, however, the dynamics associated with price floors and ceilings would undermine the overarching intent of a cap-and-trade program.

The Functions of Cash and Derivatives Markets for Carbon Trading

If a federal cap-and-trade program is enacted by Congress, a price on carbon will become a new input cost for the energy and industrial sector and a new revenue source for agricultural offset providers who supply carbon offsets into the market. The carbon price will fluctuate as market participants' perceptions of the supply and demand balance of allowances, as well as the cost of compliance alternatives, evolve over time. The two primary markets created will be: 1) a cash market to allow for the trading of allowances and offset credits; and 2) the derivatives market to allow for the trading of allowance and offset derivatives.

Allowance supply is determined by the government imposed cap and therefore is unlike most commodities. This is unlike existing and more mature commodity markets where supply is determined from various entities and external factors. Confidence in

market integrity is crucial both to effective functioning of the market and ongoing support of a market approach among both policy makers and the general public. Therefore, an essential component of the cash carbon market will be a robust registry system to track creation, ownership and retirement of allowances and offsets credits. Registries play an important role in ensuring market integrity, tracking progress toward environmental goals, and facilitating delivery for environmental commodities.

As a complement to the cash market, allowance derivatives contracts such as futures offered by the Green Exchange Venture will enable capped entities to manage U.S. carbon price movements and deploy capital for new energy projects with a greater level of certainty. For example, a risk manager working for a compliance entity, who knows she will need to purchase allowances for compliance at a specific time in the future, can lock in a price by purchasing the appropriate number of carbon futures contracts on the exchange. If the price rises, the manager will pay a higher price for the actual allowances in the cash market, but will earn a corresponding and offsetting profit on the futures position.

In addition, buyers of futures contracts can, if they choose to, take delivery of the cash allowances by holding the position until contract expiration. In this case, the buyer may be able to contract for a future supply of allowances at a lower price than what might be available upon eventual delivery, thereby lowering compliance costs. These deliveries are managed by the clearinghouse, which maintains an account with the emission registry involved in the delivery process.¹³

A compliance entity who anticipates having an excess of cash allowances as a result of the firm's efficiency in reducing emissions below its cap, can lock in a price in advance by selling futures contracts in the appropriate amount. A seller of the futures contract also can maintain their short position and deliver allowances against the contract.

The Role of Futures Exchanges, CCP Solutions and Regulators in a U.S. Carbon Market

Futures markets perform two essential functions—they create a transparent venue for price discovery and they permit low cost hedging of risk. Futures markets depend on a broad universe of market participants with both short and long term expectations to make markets and provide liquidity for hedgers. By offering trading of U.S. emission derivatives on electronic trading platforms, we believe exchanges will enhance price transparency, speed execution, and eliminate many classes of errors and mismatched trades, contribute significantly to liquidity, and will generally be beneficial to the market.

Electronic trading of exchange traded emission derivatives coupled with a comprehensive CCP solution such as the one offered by CME Clearing and utilized by the Green Exchange Venture, will reduce risk and uncertainty for carbon market participants. CME Clearing has provided clearing services for the futures industry for

¹³ The clearinghouse also guarantees the integrity and completion of delivery of the allowances.

over a century without a single default and has an industry-leading financial safeguards package of over \$7 billion that is designed for the benefit and protection of both clearing members and their customers.¹⁴

Electronic trading and CCP solutions will also provide a trustworthy and timely audit trail for regulatory purposes. In providing market and trade surveillance services to the Green Exchange Venture, the CME's dedicated and highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Through advanced technology tools, we have an audit trail that allows us to effectively identify anyone who engages in misconduct. CME also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Over the past year, CME worked closely with the CFTC and other exchanges to transition to standardized trade data reporting to the CFTC.¹⁵ These data files provide critical and timely data to the CFTC and the Green Exchange Venture is committed to continuing this practice for trading activity in our emissions products. Additionally, the CFTC receives large trader positions directly from each clearing firm on a daily basis to monitor activity and prevent market manipulation.

The CFTC assures the economic utility of the futures markets by encouraging competitiveness, protecting market participants against fraud, manipulation, and abusive trading practices, and by ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important functions of price discovery and hedging price risk. To ensure the adequacy of exchange SRO programs, the CFTC conducts routine rule enforcement reviews of each futures exchange. In the context of the rule enforcement reviews, the CFTC reviews the exchanges' trade practice and market surveillance programs, disciplinary programs and audit trail. These reviews are comprehensive and the findings and recommendations are public documents.

We believe that because of the CFTC's established expertise and coordination within the global derivatives industry, it is in the best position to provide strong regulatory oversight to a mandatory U.S. cap-and-trade market. We applaud the efforts of this Committee and the Administration to ensure that a mandatory U.S. GHG cap-and-trade program will enhance transparency, integrity, efficiency and fairness in the markets.

¹⁴ The CME Clearinghouse currently holds more than \$100 billion of collateral on deposit and routinely moves more than \$5 billion per day among the CME Clearinghouse and its clearing firms. It conducts real-time monitoring of market positions and aggregate risk exposures, twice-daily financial settlement cycles, advanced portfolio-based risk calculations, monitors large account positions, and performs daily stress testing.

¹⁵ Earlier this year, the CME and CBOT became the first exchanges to begin reporting trade data using the FIXML Trade Capture Repon format to the CFTC.

Price Transparency and Market Data Distribution

Another important aspect to an effective cap-and-trade program is access to price data for market participants, emitters, regulators, and the general public. Our real-time futures price data is disseminated to approximately 400,000 real-time data subscribers through 40 directly connected quote vendors and an additional 200 licensed vendors¹⁶. The technology employed allows for real-time market data to be disseminated in 5-10 milliseconds from the time it leaves our electronic trading system. Additionally through www.cmegroup.com, we provide free, delayed price quotes for all of our futures products.¹⁷ We strongly believe that the existing market data infrastructure, standard FIX/FAST formats, and reliability of our quote distribution technology, can provide the price transparency required to support the U.S. carbon market. This data feed can also facilitate the real-time transfer of price data to regulators with very little additional effort or cost. In our view, creating a new infrastructure for this purpose for the carbon market would be complex and costly for federal government and participants alike, which could be ultimately detrimental to establishing U.S. leadership in addressing global environmental challenges.

OTC Transactions

As beneficial as exchanges and clearinghouses will be to the formation of an effective U.S. carbon market, they will not meet all of the needs of companies seeking to meet their compliance targets. Although the Green Exchange Venture and other emissions trading platforms would likely be the presumed beneficiaries if all transactions were required to be executed on electronic trading platforms, we do not believe such a requirement would be in the best interest for a U.S. cap-and-trade program to meet its goal of cost-effectively reducing emissions.

We believe that both exchange-traded and OTC derivatives markets are essential to the efficient functioning of a U.S. carbon market. Together, these markets can provide compliance entities with the ability to increase the certainty in their future cash flows by protecting against price risks and effectively managing their capital, thereby increasing their confidence and ability to act and reducing their overall cost of compliance. Given the multitude of unique contracts traded in the OTC market and the specialized customer needs, we strongly believe that customers must be given the ability to access both exchange traded derivatives and OTC markets, if they are to effectively manage their price risk. A government mandate for exchange trading of standardized contracts as a replacement for this bespoke market will increase costs for entities with compliance obligations, and impede the ability of developers of both projects and new technologies to obtain financing on reasonable terms.

¹⁶ This data is sent on behalf of the four exchanges operated by CME Group, which include CME, CBOT, NYMEX and COMEX. CME also handles market data distribution and licensing administration services for the Green Exchange Venture.

¹⁷ In August 2009, www.cmegroup.com received approximately 9.2 million hits per day and 43% of these hits viewed quote pages for commodity products.

The OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies¹⁸. OTC arrangements are particularly crucial for financing carbon offset projects and the sale in the first instance of the created carbon offsets. Primary offset creation contracts provide the supply of offsets necessary to help contain the costs of a climate program for American consumers. Each of these carbon offset creation contracts is unique, and their customized nature lends itself to the OTC market, not exchanges.

Another example of a vital customized transaction for U.S. carbon markets would be long-term structured transactions. These transactions hedge price risk associated with investments in emissions reduction and clean energy technologies. Companies financing such investments base the repayment of loans, in part, on the cost of carbon allowances or offsets. This leaves such financing vulnerable to swings in carbon prices, which is a risk that must be hedged for financing to take place. Again, such transactions are specific to each investment and are often of such long duration that they cannot be effectively traded on an exchange.

Finally, OTC markets support the healthy functioning of exchanges themselves. Historically, products that are today traded on exchanges have started as OTC products. It is only after an OTC product achieves a degree of standardization and attains a critical mass of acceptance that it meets the qualifications for listing on an exchange. Eliminating OTC transactions could cause damage and disruption to the evolution of standardized exchange traded products.

While some types of customized transactions must be conducted OTC, the natural tendency of the majority of trades will be to gravitate to exchanges, and to utilization of clearing services, with or without any legal requirement to do so. Carbon market participants will be attracted to trading platforms that provide the highest level of liquidity and transparency, the best risk management opportunities, and highest level of financial assurance. This is currently being seen in the functioning carbon market in the EU. Carbon trading in the EU ETS began with transactions taking place exclusively OTC. In relatively short order, exchange-traded products developed. Over the last two years a distinct trend has emerged with increased liquidity on carbon exchanges and enhanced use of CCPs. According to market participants, it is estimated that over 40% of ETS EUA futures contracts are exchange traded and a predominance of OTC transactions are cleared through CCPs. All of this is occurring without any legal or regulatory requirement to do so. The EU example demonstrates not only the importance of

¹⁸ Exchange cleared transactions require posting of collateral so for some entities, the OTC market can provide more flexible financing arrangements that provide needed financial security without requiring cash. An easy to understand example would be taking a lien, or "mortgage" against the physical assets of a counterparty. This "cashless" form of collateral can be of great benefit to a project developer, a manufacturer developing a new technology, or even an established business needing to conserve cash.

exchanges in carbon market trading, but also the vital role that OTC markets play in the market's initial development – and its continued importance for customized transactions.

Improved Transparency in OTC Carbon Markets

Our view is that efficiently functioning derivative markets are essential to risk management, and that it is entirely appropriate to focus on how to improve the efficiency and security of the OTC derivative market. CME Group and the Green Exchange Venture are strong proponents of the benefits of centralized clearing of OTC derivatives as an effective means of reducing systemic risk while at the same time collecting and providing timely information to regulators. Our view derives from considerable experience acting as a central clearing party for exchange traded derivatives, and more recent experience acting in the same role for OTC derivatives based on energy and agricultural commodities.

While OTC transactions must be present in a carbon market for cap-and-trade to be fully successfully, the OTC carbon market must provide a greater level of transparency than what is currently present in some other OTC markets. We support position reporting for carbon-related OTC transactions to provide enhanced transparency. Indeed, as part of its special call reporting, the CFTC already requires extensive reporting of OTC commodity derivative positions. This framework can be leveraged and extended to include new carbon derivatives. We also recognize that this Committee, the Administration, and others are evaluating regulatory changes to the broader OTC derivatives market. We believe that any regulatory framework created for the U.S. carbon market should be crafted to be consistent with regulatory changes that may be made to the broader OTC derivatives markets.

Ensuring the Cost Effectiveness of Carbon Trading and Clearing

In effectively regulating a potentially large carbon market, the CFTC may need additional resources. However, the Committee should resist any proposal to add a transaction tax to carbon derivatives transactions. A transaction tax would directly increase the cost of doing business for the compliance entities and essential liquidity providers that will use carbon derivatives. This tax will expose them to the choice of trading on the exchange at a profit level that is unjustified for the risks assumed and likely result in them trading elsewhere. The exit of market participants will mean decreased efficiency of the futures markets, more price volatility and less opportunity for other market participants to make effective use of futures markets. Moreover, futures markets provide significant benefits to market users and to persons seeking meaningful information on future pricing in order to guide their decision making on clean energy investment and offset development. More depth and liquidity in a carbon futures market will lead to better price discovery. Any impairment of liquidity lessens the value of the information and the functioning of our markets.

A transaction tax will also discourage the use of centralized clearing. At a time when the markets are searching for increased transparency and safeguards, a transaction tax applied to the settlement of derivative contracts cleared by a Derivatives Clearing Organization (DCO), would essentially penalize those using a regulated U.S. DCO and discourage the growing use of CCP solutions. This is in direct conflict with the Administration's goal of improving the role of regulators in monitoring systematic risk.

We recognize the need to ensure that CFTC has adequate resources to effectively oversee a potentially sizable carbon market, but we strongly believe that a transaction fee on derivatives will discourage the use of the risk management tools available on transparent exchanges which will ultimately drive up the costs of a cap-and-trade program through diminished liquidity and decreased price signals.

Conclusion

Cap-and-trade is the most efficient approach to significantly reducing emissions. Entities such as the Green Exchange Venture will provide capped entities and other market participants with the venue to safely and securely manage their carbon price risks. Such exchanges and CCPs should be unimpaired from transaction taxes that could damage liquidity and discourage their use. Regulated exchanges, CCP solutions, and the CFTC, will provide a high level of transparency to the U.S. carbon markets. This existing transparency combined with added transparency to the OTC market will ensure a well-functioning carbon market that will enable compliance entities to meet their environmental obligations and agricultural and forestry offset developers to fully participate in the carbon market.



National
Corn Growers
Association
www.ncga.com

**Committee on Agriculture, Nutrition and Forestry
United States Senate**

Hearing on

**Global Warming Legislation:
Carbon Markets and Producer Groups**

Testimony of

**Fred Yoder
National Corn Growers Association**

September 9, 2009

Chairman Harkin, Ranking Member Chambliss and distinguished members of the Committee, thank you for the opportunity to testify today on behalf of the National Corn Growers Association (NCGA) regarding carbon markets. I applaud the committee's efforts to focus attention on the important role the agriculture industry has in the area of climate change and the issues facing rural America.

The National Corn Growers Association represents more than 35,000 corn farmers from 48 states as well as more than 300,000 farmers who contribute to corn check off programs and 26 affiliated state corn organizations across the country. The mission of NCGA is to create and increase opportunities for corn growers and to enhance corn's profitability and use.

My name is Fred Yoder, and I am a past president of NCGA. I grow corn, soybeans and wheat near Plain City, Ohio and have been an active participant in climate change discussions for many years. In December, I had the opportunity to attend and participate in the United Nations World Climate Conference in Poland where I was able to discuss the role of agriculture in reducing greenhouse gas emissions. In addition to being part of NCGA's efforts, I serve on the boards of numerous ad hoc groups, including the 25x25 Carbon Working Group and the Ag Carbon Market Working Group.

We are pleased that the Senate Agriculture Committee is actively involved in the climate change negotiations in Congress. Agriculture should be considered a significant part of the broader solution as we evaluate ways to reduce greenhouse gas emissions. Our nation's corn growers should have the opportunity to make significant contributions under a market based cap and trade system through sequestering carbon on agriculture lands. In fact, numerous economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program for consumers.

In the near term, greenhouse gas reductions from livestock and agricultural conservation practices are the easiest and most readily available means of reducing greenhouse gas on a meaningful scale. The United States Environmental Protection Agency (EPA) estimates that agricultural and forestry lands can sequester at least 20% of all annual greenhouse gas emissions in the United States.

Further, agricultural producers have the potential to benefit from a properly crafted cap and trade program. Given these opportunities, it is critical that any climate change legislation seeks to maximize agriculture's participation and ensure greenhouse gas reductions while also sustaining a strong farm economy.

For years, corn growers along with the rest of the agriculture industry have adopted conservation practices such as no till or reduced tillage, which result in a net benefit of carbon stored in the soil. In fact, on my farm, I engage in both no till and reduced tillage. Also, for the past five years, I have worked with my state association, the Ohio Corn Growers, on a research project with Dr. Rattan Lal of Ohio State University on soil carbon sequestration. As part of our efforts, we have on-farm research plots at six different locations to study various soils and their carbon capture capabilities. I have

been actively engaged from the beginning in defining the research protocols. This is only one example of the groundbreaking work our industry is undertaking.

NCGA has identified several priorities which I believe are critical elements to the agricultural sector within cap-and-trade legislation. We have worked closely with others in the industry to identify key principles which have been embraced by a broad cross-section of the agriculture community. A number of these priorities were addressed in the final House passed version of H.R. 2454. NCGA currently has a neutral position on the legislation while we conduct an economic analysis of the House passed bill. We expect to have preliminary results of our study in the coming weeks, which will better explain the potential cost increases and income opportunities for corn production under a cap-and-trade system.

First, NCGA supports the decision by the House of Representatives to exclude agriculture from an emissions cap, and we urge the Senate to maintain this important exemption. Any efforts to regulate greenhouse gas emissions from America's two million farms and ranches would be costly and burdensome, resulting in limited reduction of greenhouse gas emissions. Our industry accounts for only 7% of emissions in the overall economy. Therefore, it would seem unreasonable to concentrate on regulations for such a small and diffuse industry.

However, tremendous environmental benefit can be achieved by allowing producers to provide low-cost, real and verifiable carbon offsets. Congress should fully recognize the wide range of carbon mitigation or sequestration benefits that agriculture can provide. This could include sequestration of carbon on agricultural lands, reduction of emissions from livestock through dietary improvements and manure management, introduction of nitrogen and other fertilizer efficiency technologies and a variety of other practices.

In addition, agricultural offsets have the ability to significantly lower the cost of a cap-and-trade system while achieving real greenhouse gas emissions. Corn growers and other producers can provide the offsets needed to allow changes in energy production technologies as well as investments in capital and infrastructure to occur, while providing market liquidity and low-cost emissions reductions to help the market function properly. Furthermore, agricultural offsets could also spur ancillary environmental benefits in the form of clean water, air and better wildlife habitat, while at the same time enhancing the fertility and productivity of the soil resource needed to provide food, feed, fuel and fiber. Farmers have always and will continue to respond enthusiastically to market incentives.

Of course, NCGA is closely monitoring the macro-economic impacts of cap-and-trade legislation to ensure that new policies do not create an unnecessary burden for the nation's agriculture sector. We fully anticipate that the cost of fertilizer, fuel, machinery and other inputs to increase under a cap-and-trade system. Corn growers are subject to the volatility of the commodity markets with little ability to recoup costs associated with escalated input prices. Therefore, to ensure a vibrant U.S. agricultural economy in the long-term and an abundant domestic food supply, Congress should structure a cap-and-

trade system that delivers an offsets program where the value exceeds the cost to farmers and ranchers.

We believe it is important to provide an initial list of project types that are considered eligible agricultural offsets. Both the regulated community and agricultural sector need assurances that agricultural offsets will be available. The regulated community should have confidence that a sufficient quantity of offsets will be available for purchase in order to comply with a mandatory cap. The agricultural sector also needs to have clear direction on project types Congress considers to be eligible in order to assess the full impact of cap-and-trade legislation on our industry. An initial, non-exhaustive list of project types in the legislation is critical to addressing these concerns. Shifting the burden of decision-making to an entity other than Congress generates uncertainty that should be avoided. The House version includes such a project list, and NCGA is generally supportive of these provisions even if some modification of the list is necessary in the Senate.

Another top priority of our industry under a cap-and-trade system includes the role of the U.S. Department of Agriculture (USDA). NCGA feels that USDA should play a prominent role in developing standards and administering the program for agricultural offsets. The Department has the institutional resources and technical expertise necessary to oversee a program that has the potential to be massive in scope. USDA has a proven record of working with farmers, in addition to studying, modeling and measuring conservation as well as production practices that sequester significant amounts of carbon. USDA should be given adequate flexibility to implement an offset program which allows them to account for new technologies and practices that emerge. This will in turn result in emission reductions from agricultural sources. NCGA is supportive of the respective roles for USDA and EPA as spelled out in the House version of the bill, which assigns all rulemaking and implementation authority to USDA and provides EPA with a limited administrative function in the program.

NCGA also believes that an important component of creating a successful cap-and-trade system is ensuring that domestic offsets are not artificially limited. H.R. 2454 calls for two billion tons of offsets, half of which are domestic. While the legislation establishes a fairly robust offset market, current estimates predict that agricultural and forestry lands can help to reduce at least 20% of greenhouse gas emissions in the U.S. on an annual basis. Therefore, we believe it is unwise and would distort the market if this one billion ton artificial cap on domestic offsets remains in the bill. The goal should be to remove as much greenhouse gas from the atmosphere as possible. Artificial caps could prevent legitimate carbon sequestration, livestock methane capture, and manure gasification projects from occurring.

Furthermore, NCGA feels that carbon sequestration and greenhouse gas mitigation rates should be based on sound science. There is a large body of scientific data which demonstrates that agricultural soils have the ability to sequester carbon, and technologies are available to effectively measure soil carbon content. In fact, the 2008 Farm Bill included a provision that directs the USDA to develop guidelines and protocols for farmers to participate in a greenhouse gas offsets market. USDA has begun developing a properly constructed, science based model that includes statistically relevant random field

measurements to help maximize agriculture's ability to participate in an offsets market. Any new policies should include provisions for the development of future offset standards and revision of existing standards to account for changing technology and information.

It is also important that USDA establish measurement rates for various offset practices at the national or regional level. NCGA believes in a standards-based approach rather than a project-based approach for measuring offsets. Real, verifiable credits can be achieved without direct measurement of each individual offset project; however, third-party auditing can be employed to ensure the credibility of the system. Meanwhile, a project-based approach would be cost-prohibitive, particularly for smaller farming operations and would prevent many producers from participating in the offsets market. We believe that an acceptable level of accuracy is achievable under a standards-based approach with pre-calculated values based on sound science. This should not preclude the development of new technologies or innovative practices that would require initial field testing or project measuring; however, even these new types of credits should eventually transition to standard protocols and values for ease of adoption.

Concerning the question of permanence, it is important to emphasize the concept of contract duration rather than a literal definition of "permanence." The value of the carbon credit would likely have a strong correlation to the length of the contract. For instance, longer contract periods imply more risk for the seller and should result in a higher price. H.R. 2454 allows for contract periods of five, ten and twenty years, which provide realistic, workable options for agricultural producers. Policies to address reversals, both intentional and unintentional, will also need to be established. Intentional reversals should be considered a breach of contract and the seller would be held responsible based on the terms of the contract. Unintentional reversals, such as instances of natural disasters or other unforeseen circumstances, could be handled through a reserve pool or perhaps a mechanism similar to crop insurance. The bottom line is that risk must be managed appropriately for both the offset buyer and seller, and in most cases, the emphasis should be placed on contract duration rather than permanence.

An issue that continues to be of utmost importance to NCGA is the treatment of early actors and additionality in a cap-and-trade system. The agriculture industry is constantly evolving. As technologies and practices improve, farmers are converting to alternative tillage practices such as no-till or ridge-till. They are reducing fertilizer application rates and enhancing crop uptake of fertilizer nutrients. Some livestock producers are able to use methane digesters and invest in covers for manure storage or treatment facilities while others are able to reduce enteric emissions with dietary modifications. Producers who have taken these steps should not be placed at a competitive disadvantage by being excluded from compensation for future offsets that occur as a result of these ongoing efforts. H.R. 2454 acknowledges this issue by allowing carbon credits for producers who initiated sequestration practices as early as 2001; however, NCGA does not believe this language is inclusive enough.

For example, some of our members have recently begun participated in the Chicago Climate Exchange (CCX) while others have been sequestering carbon through

conservation practices outside of a trading market for many years. These early actors should not be penalized for being pioneers in the area of no-till or low-till agriculture. Planting and tillage decisions are made each year, and there is no guarantee that a producer will decide to continue the same practice as the previous season. It is imprudent to eliminate these early actors from the offset market based on this flawed assumption. In fact, even continuous no-till farms, which represent a small percentage of all U.S. acreage, have the capacity to continue to sequester additional carbon for many years in a row. The bottom line is that each and every crop we grow sequesters additional carbon, and policies should recognize this fact. In addition, Congress should not establish policies that offer perverse incentives to producers that have heretofore been sequestering carbon in the soil. To that end, NCGA supports the development of an "avoided abandonment" offset credit so that no-till producers can receive compensation for their ongoing sequestration activities regardless of when that practice began. The treatment of early actors, particularly those who initiated their efforts prior to 2001, is one major deficiency in the House bill.

It is important to note that many practices undertaken to reduce greenhouse gas emissions will provide additional public benefits, such as clean water, wildlife habitat, and reduced soil erosion. Eligible projects in a greenhouse gas offset market should not be excluded from also participating in Farm Bill conservation programs other markets for environmental services that currently exist or may arise in the future. Allowing producers to "stack" credits will maximize the economic viability of carbon sequestration and manure management projects, ensuring more projects are undertaken and synergies with other environmental priorities are developed.

Lastly, the House passed version of H.R. 2454 also includes an important provision related to the Renewable Fuels Standards. The House bill prohibits EPA from considering indirect land use change when conducting their life cycle analysis for corn based ethanol until a peer reviewed study can be conducted to verify the scientific accuracy of the current modeling. NCGA has criticized recently published data that would suggest a direct correlation between domestic ethanol production and international deforestation. The language in the House bill is a step in the right direction towards sound science a more rational life cycle analysis. We would urge the Senate to include the same provision in its version of the climate bill.

In conclusion, it is our hope that we can continue to work with the Senate Agriculture Committee to ensure Congress chooses the best path for agriculture and rural America. Finally, corn growers will continue to meet the growing demands of food, feed and fuel in an economical and environmentally responsible manner.

I thank the Committee for its time and look forward to any questions you may have.

DOCUMENTS SUBMITTED FOR THE RECORD

SEPTEMBER 9, 2009

TESTIMONY OF C. ROSS HAMILTON, PH. D.

VICE PRESIDENT OF GOVERNMENT AFFAIRS AND TECHNOLOGY

DARLING INTERNATIONAL INC.

TO THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND
FORESTRY

September 15, 2009

Darling International Inc. (“Darling”)¹ would like to thank the U.S. Senate Committee on Agriculture, Nutrition and Forestry (“The Committee”) for the opportunity to submit written testimony to the Committee’s hearing entitled “Global Warming Legislation: Agricultural Producer Perspectives and Trading Regulation under a Cap and Trade System.” The rendering of animal byproducts and mortalities is an important carbon capture/greenhouse gas avoidance technology, the benefits of which may equal or exceed the environmental benefits derived from many other important agricultural and forestry practices, such as reduced or no-tillage farming and re-forestation. As with these other conservation practices, the use of rendering services for the disposal of animal byproducts and mortalities should be encouraged. Darling therefore, urges the Committee to recognize rendering and similar technologies that avoid greenhouse gas emissions by capturing and using carbon and nitrogen from waste products as eligible domestic agricultural and forestry offset practices.

¹ Darling is publicly traded, which limits information that can be disclosed. Industry data will be used instead where appropriate. Darling’s public filings and other information about the company are on its website www.darlingit.com.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

Description of Darling International Inc.

Darling, the largest and only publicly traded independent rendering company in the United States, is one of America's leading providers of rendering, recycling and recovery solutions to the nation's food industry. Rendering companies, such as Darling, collect the remains of animals that die outside of the food chain (i.e. on the farm) and materials that would otherwise be discarded, such as meat and slaughter byproducts and used cooking oil from the restaurant industry, and process these inedible wastes to make useable products such as animal fats, recycled cooking oil and animal proteins. These finished products are used as animal feed ingredients, by the oleo-chemical industry and to make biofuel, as previously described for Congress by the Congressional Research Service². Darling is a U.S. agricultural-based company that employs more than 1850 people to operate 83 registered facilities located in 24 states. This infrastructure is used to provide services in more than 33 states to approximately 116,000 farmers, ranchers, butcher shops, independent meat and poultry processors, grocery stores and food service establishments. In addition to its collection, blending and manufacturing facilities, Darling's headquarters are located in Irving, Texas. Darling recognizes its responsibilities in areas such as environmental protection, animal feed/pet food safety and animal health and has a long history of public policy engagement in these and other areas at the state and federal level. Darling includes reasonable solutions to regulatory problems when commenting on relevant rulemaking to regulatory agencies, such as the Food and Drug Administration (FDA), services within the United States Department of Agriculture (USDA), U.S. Environmental Protection Agency (EPA) and the California Air Resources Board (CARB).

Rendering services are essential to the sustainability of animal agriculture

Typically, the agricultural practices considered as eligible sources of offsets are agronomic practices such as changing cropping patterns, reduced tillage, forest/grassland conservation, reduced deforestation and others that sequester carbon in plants and/or the soil to delay the release of greenhouse gases. Without diminishing the importance of carbon sequestration, practices that prevent greenhouse gas production may provide a more permanent way to reduce climate change.

² CRS Report for Congress RS21771, Animal Rendering: Economics and Policy, 2004. This report was prepared for Congress after bovine spongiform encephalopathy (BSE) was detected in the U.S. Since CRS issued this report, fats from rendering have become more important as a biofuel and as a feedstock for biodiesel and renewable (green) diesel.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

Such greenhouse gas avoidance strategies considered in H.R. 2454 that are available to animal agriculture, include dietary modifications to reduce methane production in cattle and manure management to either reduce or capture methane for use as a fuel. Rendering is also an effective technology for capturing and recycling carbon and should be treated comparably to these other agricultural practices as the Committee develops its list of eligible offset practice types. Darling and other rendering companies are important agri-businesses that provide essential services to animal producers, as well as meat packers, meat processors, and others in the food industry. Without such services, it would be difficult for the animal production and meat industries to remain environmentally sustainable.

USDA estimated that in 2008 more than four million cattle and calves and nine million pigs died on farms or prior to slaughter³. Commercial and on-farm slaughter of cattle, pigs and lambs resulted in another 26 billion pounds of inedible animal byproducts.⁴ The poultry industry also generates large volumes of poultry mortalities and byproducts each year. Without rendering, animal producers and meat processors would have to find alternative methods for the disposal of their dead animal remains and animal byproducts. These are putrescible materials that will readily incubate diseases, pollute the environment and release greenhouse gases, if not properly handled. Only rendering can address all of these issues. Rendering is the most efficient and environmentally sound disposal alternative for the disposal of these animal remains. Despite its efficacy for greenhouse gas avoidance, however, rendering was omitted from the Agricultural and Forestry Related Offsets Title of H.R. 2454. Rendering and related practices that capture and recycle the carbon from animal, as well as, plant remains should be included as eligible offsets in this or a new Title.

Justification for rendering as an eligible offset practice or project

Title V, Subtitle A of H.R. 2454, covers the Offset Credit Program from domestic agriculture and forestry sources. Key terms, such as *offset credit*, *offset practice* and *offset project* are defined in §501 (a). Darling believes that the process of rendering should satisfy the definition for either an *offset practice* or an *offset project* and that the rendering of animal remains should satisfy the definition for *offset credits*. The carbon and nitrogen in animal remains is captured by

³ USDA National Agricultural Statistic Service, Meat Animal Production, Disposal and Income 2008 Summary.

⁴ USDA National Agricultural Statistic Service, Livestock Slaughter 2008 Summary. Total inedible byproducts calculated from red meat production and number of head and average weight at slaughter.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

rendering and recycled into useable products, thus avoiding their conversion to carbon dioxide (CO₂), methane (CH₄) and nitrous oxide (N₂O) gases. Based on greenhouse gas production measured as animal remains decompose⁵, one metric ton of carbon dioxide equivalents (CO₂e), which should qualify for issuance of one offset credit, will be avoided for each 1,065 pounds of animal remains recycled by rendering. Recognition of the rendering process as an eligible offset practice or project would therefore, allow a farmer or a rendering company to receive one offset credit for trade or to use, whenever the remains of a mid-sized cow is rendered. This would ultimately benefit the farmer either directly when he trades the credit, or indirectly when a rendering company applies the value of the credit against the cost of rendering an animal's remains. The value of the benefit would depend on the market value of the credit under a federal cap and trade system.

Section 502 instructs the Secretary of Agriculture to establish a governance program to ensure that certain minimum standards are met in order to generate offset credits from domestic agriculture and forestry sources. Darling agrees that the Secretary of Agriculture should administer agricultural derived offsets under a federal cap and trade system. Darling also agrees that offset credits must be verifiable and issued only when activities result in permanent reductions of atmospheric greenhouse gases. Darling disagrees however, that offset credits can only represent additional greenhouse gas emission reductions for agriculture. This additionality requirement may be applicable for reducing greenhouse gases from combustion emissions, a major contributor to increasing levels of atmospheric greenhouse gases. Additionality may not be appropriate for agriculture which has traditionally used practices that reduce greenhouse gas emissions by either sequestering carbon (such as reduced tillage or converting crop land to grass) or capturing and recycling carbon (such as recycling of plant and animal byproducts). Therefore, additionality should be used judiciously and not broadly applied for agricultural offset practices, projects or credits. In contrast to methods for decreasing industrial combustion emissions, which may be accomplished by applying engineering solutions or using capital to upgrade facilities, agriculture is based on complex biological systems which may not respond predictably to new engineering or capital. Indeed, basing the eligibility of a practice on a calendar date will incentivize the adoption of new practices and discourage the use of established practices that may be more effective. The goal should be to obtain a measureable net reduction in atmospheric

⁵ S. Xu, X. Hao, K. Stanford, T. McAllister and F. Larney, "Greenhouse Gas Emissions during Co-Composting of Cattle Mortalities with Manure", *Nutrient Cycling in Agroecosystems*, Vol. 78, 2007, pp. 177-187.

greenhouse gas levels. This will not be achieved if the net result of replacing an established practice with a new one is an increase in greenhouse gas emissions. Such unintended consequences are illustrated in the following examples:

- *Scenario 1.* Converting land used for crop production to grassland might be an eligible practice if it was converted after January 1, 1999, but not if the grass was established prior to this date. A farmer interested in offset credits might be encouraged to convert a block of land seeded in grass prior to 1999 back to crop production. To gain the offset credit, the farmer may then either seed a new block of land to grass or seed grass on the original block after raising crops on it for a requisite period of time. In this scenario, the farmer might receive offset credits from a net increase in greenhouse gases emitted when the grassland was tilled, which released carbon sequestered in the plants and soil, and from the farm machinery used for tilling and reseeded.
- *Scenario 2.* Recycling practices in agriculture are particularly vulnerable to unintended consequences caused by additionality. Capturing methane in landfills and flaring it off or using it as a fuel will likely be an eligible offset practice. Animal and plant remains would be excellent sources of methane gas in a landfill. If the rendering of animal remains (or recycling plant remains) is not also an eligible offset practice, the value of offset credits may encourage the diversion of animal remains from rendering to landfills. In this scenario, the landfill would receive offset credits for capturing greenhouse gases which had been avoided by rendering before the material was diverted to the landfill. A net increase in greenhouse gas emissions would result from flaring the methane or burning it to make electricity.

In order to prevent such unintended consequences and to assure that offset credits are issued only for practices that can be verified to permanently and actually reduce atmospheric greenhouse gases, the Committee is urged to avoid making additionality a basic requirement for eligible agricultural and forestry practices.

In addition to giving the Secretary of Agriculture the authority to develop a list of domestic agriculture and forestry practices eligible to generate offset credits, §503 lists minimum practices

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

to be included. Neither rendering nor any other carbon capture/recycling practice is included as one of these minimum practice types. Darling encourages the Committee to recognize the greenhouse gas reduction potential of rendering and similar practices by including rendering in this list of minimum practices. Rendering may be included either directly as a named eligible carbon offset practice or through a general statement that acknowledges recycling efforts in agriculture and lists rendering as an example. Possible language the Committee may consider is: "Practices that capture and recycle carbon from agricultural materials to avoid greenhouse gas release into the atmosphere, such as rendering, shall be considered as eligible offset practices".

The Role of Rendering in Greenhouse Gas Avoidance

Each year, the U.S. rendering industry processes 60 billion pounds of animal mortalities and animal byproducts⁶. Unless stabilized by rendering or a comparable process, these materials decompose rapidly, with the rate being influenced by environmental conditions. Because animal remains consist primarily of water, carbon and nitrogen, greenhouse gases such as CO₂, methane and nitrous oxide are produced and released as the remains decompose. Essentially all of the carbon will be converted to CO₂ or methane, depending on the availability of oxygen during decomposition. If oxygen is readily available, as in properly composted material, CO₂ will be the primary gas produced. Limiting oxygen during decomposition, as may occur in a landfill, will shift gas production to favor more methane and less CO₂. Almost 5 million metric tons of carbon and 500,000 metric tons of nitrogen are captured annually by rendering.⁷ This amount of carbon is enough to form 17.5 million metric tons of CO₂. Rendering has a very positive carbon footprint⁸. A typical rendering plant captures and recycles more than seven times more CO₂e than it emits, when all emissions associated with collection, transportation and processing animal remains are considered. Based on greenhouse gas production measured when cattle remains were composted,⁹ composting all of the material that is rendered in the U.S. each year would release 39 million metric tons of CO₂e. Placing these same materials into landfills could result in 120 million metric tons of CO₂e being produced each year, assuming landfill gas is 50% methane and 50% CO₂.¹⁰ Burial of carcasses is restricted or prohibited in many areas of the U.S. due to the potential for

⁶ National Renderers Association website www.nationalrenderers.org.

⁷ National Renderers Association Issue Paper, "Rendering and Its Role in Capturing Carbon Emissions," June 2009.

⁸ National Renderers Association, <http://nationalrenderers.org/environmental>

⁹ Xu, loc. cit.

¹⁰ EPA Office of Air and Radiation, "Frequently Asked Questions About Landfill Gas and How It Affects Public Health, Safety and the Environment", June, 2008.

ground and surface water contamination. When animal remains are buried however, greenhouse gases, such as CO₂ and methane, are produced as the remains decompose underground.¹¹ These gases will escape into the atmosphere if the site is disturbed or gas pressure builds as gases accumulate (as in multiple carcasses in the same burial site) until the gases erupt through the surface.

Facilities that concentrate cattle in large numbers on a single site, such as dairies and feedlots are the most dependent on rendering because of carcass disposal and animal health concerns. A 2005 rendering industry study concluded that 45% of the remains of all cattle that die prior to slaughter in the U.S. each year are rendered.¹² Rendering the remains of all of these cattle avoids the production of more than one million metric tons of CO₂e per year. Emissions from rendering a 1400 pound cow will total approximately 0.09 metric tons of CO₂e, but the formation of 1.32 metric tons of CO₂e will be avoided, resulting in a net greenhouse gas avoidance of 1.23 metric tons of CO₂e.¹³ Rendering is also important to other sectors of animal production, such as pork production. The remains of 67% of all pigs that die prior to slaughter in the U.S. are rendered, based on results of another industry study.¹⁴

Changes the FDA has recently made to its regulations for animal feed and pet food could decrease the number of cattle mortalities that are rendered from 2005 levels. On April 26, 2009, FDA strengthened existing feed safeguards that were put in place in 1997 (21 CFR §589.2000) to prevent the spread of bovine spongiform encephalopathy (BSE; "Mad Cow Disease") among cattle and other ruminant animals in the U.S. Enforcement of these new regulations (21 CFR §589.2000 and 2001) will begin on October 26, 2009 and prohibit the inclusion of brain and spinal cord from cattle 30 months of age or older in feed or food for any animal. These tissues were already prohibited, along with others, from human food, so the rule will have a small impact on the rendering of waste materials from cattle inspected by inspectors from USDA's Food Safety and Inspection Service (FSIS) or state meat inspection services and passed for use in human food. However, for cattle not inspected and passed, such as cattle that die prior to slaughter, the entire carcass will be considered to be prohibited for use in any animal feed, if the brain and spinal cord

¹¹ A. Nutsch and M. Spire, "Burial", in *Carcass Disposal: A Comprehensive Review*, ed. by National Animal Biosecurity Consortium, August 2004, pp 43-44.

¹² Informa Economics, "Economic Impacts of Proposed Changes to Livestock Feed Regulations", December 2005.

¹³ Based on carbon footprint determinations by Darling International Inc. for rendering facilities and greenhouse gas production during composting by Xu, loc. cit.

¹⁴ Sparks Companies Inc., "Livestock Mortalities: Methods of Disposal and Their potential Costs", March 2002.

are not removed prior to rendering. Removal of the brain and spinal cord from the remains of dead cattle will be labor intensive for renderers because rendering facilities are not designed to handle cattle carcasses the same way that beef packers do. In addition, soft tissues such as the brain and spinal cord decompose rapidly, especially during the summer, which makes them difficult to remove effectively during certain seasons or if the remains are not received by the renderer soon after death. These decomposition issues combined with the higher labor and disposal costs renderers will incur in order to comply with the new feed regulations are expected to reduce the number of cattle mortalities that will be rendered under the new feed regulations. The rendering industry estimates FDA's new feed regulations will decrease the number of cattle mortalities rendered by 66.7%¹⁵.

The proportion (55%) of cattle that die in the U.S., but are not rendered today, may contribute approximately 1.5 million metric tons of CO_2e per year to the atmosphere (assuming gas produced during decomposition is similar to rates observed for composting¹⁶). The anticipated diversion of cattle mortalities away from rendering and to other disposal options under the new FDA feed regulations, may further increase greenhouse gas production to 2.2 million metric tons of CO_2e per year. In addition, diverting animal remains away from rendering can damage the environment in other ways, such as contributing to nitrogen and phosphorus loading of soil and surface/ground water as well as threaten animal and human health.

The primary economic value for animal protein meals is as a feed ingredient. If the remains of dead cattle that are 30 months of age and older are rendered without first removing the brain and spinal cord, the animal protein meal that is produced will be prohibited for use in the feed or food of any animal by the FDA, under its new feed regulations. Furthermore, renderers must keep these prohibited materials separate from material that is free of the prohibited material. Therefore, in order to render cattle remains without removing the brain and spinal cord, the renderer would have to charge the farmer enough to recover the value of the protein meal that must be disposed of because it cannot be sold for use in feed. Most cattle producers will not pay these additional charges, which is why renderers have been unable to justify dedicating a separate processing line or facility for use as a disposal rendering operation. Including rendering as an eligible agricultural offset practice so that the rendering of cattle remains could qualify for offset

¹⁵ Informa Economics, *loc. cit.*

¹⁶ Xu, *loc. cit.*

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

credits may make disposal rendering feasible (depending on the value of the offset credit) and encourage rendering as a means for disposing of all cattle remains. Encouraging the use of rendering as a disposal method would reduce emissions of greenhouse gases, as well as reduce the release of infectious bacteria and viruses and other potentially harmful agents into the environment. Cattle producers potentially benefit because either they would receive carbon offsets that can be traded to pay the additional service fees renderers will charge for disposal rendering or renderers may not have to raise their service fees.

Even if additionality remains as a basic requirement for agricultural offset practices, rendering should still be an eligible offset practice. It has already been pointed out that 55% of the cattle and 33% of the pigs that die in the U.S. each year are not being rendered today. With the new FDA feed regulations pending in a few weeks, this number will likely increase. Under a federal cap and trade system, rendering the remains of approximately 75% of the cattle that die each year should be eligible for offset credits. Incenting farmers to dispose of their animal remains through rendering would have a measurable impact on reducing greenhouse gas emissions. Renderers would also be encouraged to dedicate processing lines or facilities for disposal processing.

The relative importance of the greenhouse gas avoidance potential of rendering to agriculture can be made by comparing it to the carbon sequestration potential of land enrolled in the Conservation Reserve Program (CRP). Land in the CRP has already been considered eligible as a carbon offset for trade on the Chicago Climate Exchange. The CRP is administered by the Farm Service Agency of the USDA. According to USDA, there are approximately 35 million acres of land previously used for crop production that have been seeded in grass, shrubs and trees and are currently enrolled in the CRP¹⁷. Some aggregators validating carbon credits for trading on the Chicago Climate Exchange have offered up to 0.75 metric tons of carbon credits per acre¹⁸. If this rate is applied to all CRP enrolled acres, it would represent approximately 26 million metric tons of CO₂e as being sequestered per year. Although it is important for agriculture to consider both CRP and rendering as important greenhouse gas reduction strategies, rendering currently avoids the production of 1.7 times more greenhouse gases than CRP, when the annual impact of

¹⁷ USDA, "USDA Issues \$1.8 Billion in Conservation Reserve Program Rental Payments" News Release, October 1, 2008, Release No. 0251.08

¹⁸ Nebraska Farmers Union, "Nebraska Farmers Union Announces Carbon Credit Program for All Nebraska Counties & New Rangeland Management Program," April 19, 2007, News Letter. (<http://nebraskafarmersunion.org>).

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

CRP is compared to the greenhouse gases avoided (39 million metric tons of CO_2e) when material is rendered as opposed to composting.

Verifying the amounts of carbon and nitrogen captured for recycling can be easily documented. Darling already possesses much of the information necessary to verify the carbon and nitrogen content of the materials it recycles as well as records needed to identify farmers, ranchers, meat processors and others that send animal remains to Darling for rendering. The chemical composition of the animal protein meals and animal fats derived from rendering is easily done using validated procedures. Darling routinely collects samples of all of its finished products to monitor product composition. In addition, all of Darling's recycling facilities are individually registered with the FDA pursuant to § 415 of the Federal Food, Drug and Cosmetic Act and 21 CFR Part 1, Subpart H. All Darling rendering facilities are also registered with FSIS/USDA as required under 9 CFR § 320.5. Darling also complies with FDA regulations (21 CFR §589.2000 and 2001; 21 CFR Part 1, Subpart J; Section 417 of the Food, Drug and Cosmetic Act) that require that records be kept of all incoming materials for processing, including the name and address of the source and weight of the material and all outbound materials, including the name and address of the buyer/consignee and weight of the material. Such records are to facilitate traceability one-step backward and one-step forward in the supply chain.

Conclusion

Rendering is an effective method for collecting, processing and recycling the remains of dead animals and meat processing wastes. These materials are highly putrescible and release greenhouse gases as they decompose. Designating rendering as an eligible offset practice in climate change legislation approved by the Senate will promote the responsible disposal of these animal remains and avoid unnecessary CO_2 , methane and nitrous oxide emissions. Including rendering as an eligible offset practice will provide an important measureable offset to the agricultural community.



Senate Agriculture Committee Written Testimony
Global Warming Legislation: Carbon Markets and
Producer Groups

September 16, 2009

Senate Agriculture Committee Testimony
September 16, 2009
National Milk Producers Federation

Mr. Chairman, Ranking Member and members of the committee: thank you for the opportunity to submit agriculture's views on climate change legislation. My name is Jerry Kozak and I am the President/CEO for the National Milk Producers Federation (NMPF). NMPF develops and carries out policies that advance the well being of dairy producers and the cooperatives they own. The members of NMPF's 31 cooperatives produce the majority of the U.S. milk supply, making NMPF the voice of more than 40,000 dairy producers on Capitol Hill and with government agencies.

The House of Representatives passed H.R. 2454, our organization appreciates the fact that the bill's authors did not regulate agriculture under the cap-and-trade system they propose in the bill. NMPF supports the concept of cap-and-trade as long as agriculture is not a capped industry. However, NMPF remained neutral on the overall bill passage because it is still unclear what impact will be felt on the dairy industry. This is why it is critical that before this bill becomes law, Congress must address a number of concerns. My testimony today will focus on the specific context of offsets and allowances from which we view this bill and climate change policies overall and the changes we would like to see the Senate correct starting from H.R. 2454.

The Dairy Farm Economic Crisis

It has been a very difficult year for dairy farmers. And we have greatly appreciated all of your help and support as farm level milk prices headed sharply lower creating tremendous economic stress and pressures in the dairy farming community. The price that farmers were receiving for bottled milk was down nearly 50% from last winter. Current prices received by farmers do not even cover the cost of feed. The reason farm prices have declined so drastically is due to the slowdown in the US and global economy with the end result of a precipitously drop in U.S. exports. The problems in the global economy and the effects on consumers' buying habits are adding to that downward pressure.

Dairy Farmer's GHG Commitment

Despite these severe economic challenges, dairy farmers and their cooperatives have maintained their deep commitment to reducing their GHG emissions on farm and throughout the dairy chain. Our industry has voluntarily committed to an action plan to reduce the carbon footprint of fluid milk by an additional 25% by 2020. Work is underway throughout the dairy industry to help achieve this goal. We are looking at

farm practices ranging from dairy feed systems, efforts to reduce enteric methane production, to farm energy audits, and addressing barriers to methane digesters. At the processing level, practices being examined include items like non-thermal UV technology as an alternative to heat-based pasteurization, increased energy efficiencies in dairy plants, improved transportation systems, as well as product packaging and delivery systems.

One of the primary challenges standing in the way of wider adoption of these opportunities is the significant cost entailed. We are hopeful that an offsets market could make many of these GHG reduction practices and processes more affordable and widespread in our industry.

Dairy Sector's Strong GHG Performance Historically and Today

There have been inaccurate perceptions that animal agriculture is a significant contributor to U.S. greenhouse gas emissions. In fact, the modern dairy sector has improved its performance on GHG emissions dramatically over the last 60 years and any effort to return to the production systems that prevailed in the 1940s would have a disastrous effect on our industry's GHG performance.

EPA has reported that animal agriculture is responsible for approximately 2.5% of US GHG emissions, about half of which is enteric fermentation (1.7% of total).¹ As these statistics show, modern US livestock agriculture is a very small portion of US emissions. Manure methane and nitrous oxide emissions from dairy cows, as reported in the EPA Inventory, are only about 0.3% of total US emissions of all GHGs on a CO₂ equivalent basis. The emissions from all livestock are only about 0.8%.²

Research conducted recently at Cornell University and published in the Journal of Animal Science explores these questions and finds that the most efficient and environmentally friendly way to raise dairy cows and produce milk is definitely not the use of the dairy farm systems that prevailed before the advent of modern commercial farming. The article, entitled "The environmental impact of dairy production: 1944 compared to 2007," found that:

Modern dairy practices require considerably fewer resources than dairying in 1944 with 21% of animals, 23% of feedstuffs, 35% of the water, and only 10% of the land required to produce the same 1 billion kg of milk. Waste outputs were similarly reduced, with modern dairy systems producing 24% of the manure, 43% of CH₄, and 56% of N₂O per billion kg of milk compared with equivalent

¹ Environmental Protection Agency (EPA), 2008. "Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990-2006. EPA, Washington, DC. Calculated from statistics provided in tables ES-2 and 6-1.

² The other .2% of emissions associated with livestock production comes from nitrous oxide.

milk from historical dairying. The carbon footprint per billion kilograms of milk produced in 2007 was 37% of equivalent milk production in 1944.”

Not surprisingly, the dairy sector's total carbon footprint has also been dramatically reduced. Total GHG emissions for the dairy sector in 1944 was 194 million metric tons in CO2 equivalents. By 2007 this had been reduced by 41%, to 114 million metric tons. The article closes with, “Contrary to the negative image often associated with ‘factory farms,’ fulfilling the requirement for dairy products of the US population while improving environmental stewardship can only be achieved by using modern agriculture techniques.” Modern US dairy farming is a tremendous example of how the world can produce the goods and services needed by people, in this case the very food we eat, and doing so while producing less GHGs per calorie of food.

Dairy producers and the entire dairy chain are committed to meeting these goals. It is from our dairy sector's commitment to continuing this record of GHG performance while helping feed the US and the world and helping our businesses thrive that we offer the following comments on H.R. 2454.

1. **The bill must maintain a strong role for USDA.** H.R. 2454 recognized the importance of USDA to establish, audit and implement all the offsets standards and protocols for the agricultural offsets program. USDA has the technical understanding of the various practices that can generate offsets and has done research on how to measure GHG reductions or sequestrations coming from these practices. USDA also has the relationships with ranchers and farmers to facilitate the implementation of the program. USDA has the infrastructure to manage such a program – with county extension offices across much of the country. We understand that there is a necessary role for EPA to play in overseeing the environmental integrity of the offsets program, and feel that EPA and USDA should work jointly together to ensure that the agricultural offsets assist in the overall goal of the climate change program.

USDA is best positioned to create technical standards and protocols for GHG emissions reductions and sequestration from the agricultural and forestry sectors. Nearly all of the scientific data and documentation behind existing agricultural and forestry standards used by carbon registries is grounded in work conducted by USDA scientists or their land grant university partners. Thirteen of USDA's Forest Service scientists shared in the Nobel Peace prize for the UN Intergovernmental Panel on Climate Change report connected to their forestry work. USDA's Natural Resource Conservation Service, Cooperative State Research, Education, Farm Service Agency and Extension

Service, Economic Research Service and Agricultural Research Service have done similar work for agricultural practices that reduce GHG emissions and sequester carbon, such as methane capture and conservation tillage. USDA also has the institutional resources, administrative structure, and established relationships in place to engage farmers and ranchers across the country. USDA has tens of thousands of employees working with agricultural producers on various conservation issues. The relationships that USDA has with farmers and ranchers allow it to have the trust necessary to create, administer as well as drive higher levels of participation in the offset program. Indeed, their field assets, technical expertise and the level of trust that USDA has developed make it uniquely positioned. For these reasons § 2709 of the 2008 Farm Bill gave USDA the authority to create technical standards to facilitate participation in emerging carbon, water or other ecosystem service markets.

Since EPA will be charged with administering the overarching cap-and-trade system, we would expect EPA to review the integrity of the offset program. In that regard, EPA can periodically review the standards, protocols and verifications systems established by USDA to ensure that they are being successfully implemented into the larger cap and trade system.

2. **The bill's requirement for additional "performance standards" must be clarified so that CAFOs are not included in "back-door" climate regulation.** Section 811 of H.R. 2454 tasks EPA to set standards for regulatory compliance measures that would be required of some uncapped sectors. The criteria listed for this section could include some of the larger CAFOs in the livestock industry and would therefore remove these operations from being able to provide offsets and would instead require measures such as digesters to reduce their emissions as part of the performance standard for their category. While enteric emissions from animals are not counted, nothing is mentioned about methane or nitrous oxide emissions from manure or from combustion processes. It needs to be made clear that emissions from all agricultural and livestock activities are not regulated – either directly by the climate emissions cap, or indirectly by the performance standards. This clarity would reflect the promises that lawmakers sponsoring all climate change bills have long made to the agriculture industry that the sector shall not be regulated.

Methane digesters are a tested and proven technology however, the costs for installation, maintenance with limited return, prohibit many farms from

taking the leap to install them. Cost could range from \$2 to \$5 million to install a digester on a dairy farm. Through a cap-and-trade market, more farms will install digesters because it will become economically viable for additional producers to take the next step. However, if all producers were required to install methane digesters with no economic compensation through these performance standards, it would drive a significant number of them out of business.

The potential problem for the livestock industry comes if they are determined to have emitted at least 10% of the uncapped methane emissions in 2005 and/or were deemed to be responsible for emitting at least 20% annually of the uncapped GHG emissions. These triggers could mean that performance standards which are not detailed in the House passed version, could be applied to the livestock industry. Even if regulations are not imposed, if the 10,000 ton emission level is met, GHG reporting would likely be required.

Another area of concern comes from the fact that the performance standards themselves remain unknown. That is, this section requires the EPA administrator to come up with regulations, but does not specify exactly what will result from this process – leaving a big unknown for the industry and an unintended situation.

3. **The bill should shorten the time allowed for setting up offsets program standards.** Section 732(a) of the Waxman-Markey bill creates an offset program via regulation “Not later than 2 years after the date of enactment of this title”. As written, it is probable that regulations establishing an offset program will not be in place when the cap-and-trade system takes effect. Having regulations in place early will allow the necessary infrastructure to develop to establish a carbon market that can complete transactions and trades. Agricultural and forestry offset projects are currently being created across the country and in other countries under voluntary private and State or regional carbon markets. The Clean Development Mechanism (CDM) in the Kyoto Protocol, the Chicago Climate Exchange (CCX), the Regional Greenhouse Gas Initiative (RGGI), and California’s Climate Action Review Board (CARB) all are examples of systems with existing carbon protocols and markets, providing ample precedent from which a federal program can be crafted. Further, under the 2008 Farm Bill USDA has been charged with establishing protocols for carbon and other ecosystem service markets. The government of Canada is establishing a carbon offset program (to include
-

agricultural and forestry offsets) in 2010, and the carbon trading program in 2012, to ensure the availability of offsets at the start of the system.

4. **The bill must recognize and reward the avoided emissions efforts undertaken by agricultural leaders to reduce GHG emissions and/or sequester carbon.** Significant numbers of agricultural and forestry landowners have already undertaken actions that reduce GHG emissions or sequester carbon. These early actors should be eligible for compensation for the avoided emissions. The reason this is so important is because the greenhouse gas reductions and sequestration performed by early actors is not required by law and can be undone if the current bill's perverse incentive is not corrected. In order to maintain these avoided emissions – or emissions that could otherwise be emitted, there must be compensation. The House bill has a very limited recognition of early actors and the Senate bill should correct this issue.

Congress must recognize and reward the early efforts undertaken by agricultural leaders to reduce GHG emissions and/or sequester carbon. Significant numbers of agricultural and forestry landowners have already undertaken actions that reduce GHG emissions or sequester carbon. Changes in management taken by these early actors include, but are not limited to, switching to or maintaining zero tillage ("no-till"), using new technology to capture methane for improved animal waste management, and afforesting or reforesting buffers or larger ecosystem landscapes. These early actors should be eligible for compensation for the on-going GHG emissions reductions or carbon sequestration that they achieve within the offset program, if they qualify under all other offset protocols

The treatment of early actors is vital to agriculture's participation in a climate change system. Producers across the American landscape have been engaged in innovative efforts to sequester carbon using a variety of techniques. These producers should be allowed to participate in the offset program being created by Congress under a cap-and-trade regime. The central purpose of any offset program is to encourage the widespread adoption of conservation or other practices that reduce GHG emissions or sequester carbon and which in turn reduces, and potentially reverses global warming impacts, as well as provides cost containment for the entire cap-and-trade system. Agricultural producers who have already begun to experiment with GHG emissions reductions and carbon sequestration

practices, techniques and projects are critical emissaries to promote and ensure widespread adoption of these practices. In fact, these early actors often are the leaders of agricultural organizations and their leadership is needed to constructively engage their organizations and their membership on climate change policy. Thus, by rewarding early actors we support constructive political engagement by agriculture and we create a core group of emissaries who will encourage offset projects.

Allowing early actors' projects to be eligible does NOT automatically result in offset credits being issued for previous reduction activities. Early actor projects, like any other project, would have to comply with all other offset protocols for the practice, technique or project type that they are engaged in. Thus even if a producer adopted a practice in 2002, if that producer does not meet other offset protocols he will not be eligible to provide offset credits. Further, early actors will not be paid for GHG emissions reductions or carbon sequestered retroactively. Instead, they will be paid for future GHG emissions reductions or carbon sequestration. As an example, if a producer began no till in 2002 and his soil is projected to reach saturation in 25 years then that producer will only be paid for carbon sequestered between the date any cap-and-trade system starts and 2027.

5. **The agricultural sector should be provided with an allocation of allowances, or a portion of allowance auction revenues.** While climate change legislation will impose higher input costs (such as fuel and fertilizer) for agriculture as a sector, producers have an extremely limited ability to pass higher costs along to downstream purchasers. Agricultural producers are typically price takers in economic terms and in such a situation an allowance allocation, or the proceeds of an allowance auction, could serve to smooth the transition for producers, especially those that are not in a position to capture potential offset credit benefits. Small producers for example are less likely to be in a position to generate offset credits—it may be a simple matter of the amount of credits that they could generate not warranting the cost of changing the practice or the cost of compliance to verify the offset credits themselves. Allowance set asides, or the proceeds from an allowance auction, should be used by USDA to smooth the transition for at-risk agricultural producers as we establish a new carbon reduction system.

The agricultural sector faces unique challenges in dealing with the impacts of climate change as it begins to impact our nation and world. Agricultural producers experience and are impacted by climate and weather changes

perhaps more than any other sector; for most farmers and ranchers changes in moisture, temperature, and alterations in the growing season directly impact the ability to produce the food and fiber our nation and world need. As such, allocating allowances or allowance revenues for research into adaptation is vital. New seeds, new technologies and new techniques will be needed for the farmer and rancher of the future to produce the same vast quantities of food that we enjoy today. As global populations continue to expand, the American producer will be called upon to produce even more, and government aided research efforts into adaptation can help achieve that objective.

Farmers and ranchers are creative and innovative. As carbon markets develop, new techniques, practices and technologies for reducing GHG emissions and for sequestering carbon will be developed, yet funding could be vital to bridge the development phase for producers. Allowance allocations, or the proceeds of an allowance auction, could serve to encourage the development of these yet to be discovered carbon sequestration or emissions reduction methods—allowances could in effect serve as a bridge as data is collected and verified. Eventually, after an appropriate developmental phase, some of these techniques could be certified as accredited offsets, and thus would no longer require allowance funding.

6. **Offset eligibility and compensation should be based on whether a project, technique, or practice sequesters carbon, or otherwise reduces greenhouse gases (GHG) from a date certain.** Use of the BAU methodology in the Waxman/Markey bill will limit the amount of GHG emissions reductions or carbon sequestration by agriculture and forestry. The central purpose of the legislation is to reduce or eliminate as much CO₂ as possible, yet by using a BAU methodology to determine project eligibility limits the amount of low cost offsets that will be provided. Section 734(a)(1) requires that offset projects conform to a standard methodology that will determine whether the offset project is BAU for an industry. The text further provides that the government can change baselines, perhaps significantly, on a regular basis. This unnecessarily creates a high level of uncertainty for agricultural producers and investors regarding whether offset projects they are undertaking or about to undertake will qualify for offset credits. Uncertainty in turn will dampen the level and scale of participation in an offset program, and hence the success of the offset program, which is an important component of cost-containment in a cap-and-trade system.

By applying this type of updated BAU test for additionality the draft also ensures that the “hardest” or least likely projects or producers (i.e., those least likely to participate at modest prices and early stages of a program) will never participate. Rather than actively ignoring or omitting the “hardest” projects/least environmentally sensitive producers, an offset program should specifically strive to reach this population. Further, the logic of this type of BAU methodology devalues carbon emission reductions overtime. Projects that produce real, verifiable GHG reductions should receive credit.

To give one example: currently there are approximately 125 methane digester systems across the country, accounting for less than 1% of all dairy, hog, and beef cattle operations. Congress should enact a statute that incentivizes the installation of more digesters – striving for 100% penetration, for instance -- rather than deciding that at 50% market penetration the practice is considered BAU and will no longer receive offset credits. Thus digesters installed when market penetration is at 45% are just as valuable to GHG impacts as digesters installed at 95% market penetration (and perhaps more so, if early reductions have already been achieved, and we are seeking the latter, “harder” reductions); each of these digesters should receive just compensation for the emissions reductions delivered—actual tons of GHG destroyed—and not be dependent on when they were built in relation to each other.

The Waxman/Markey bill changes baselines over time unfairly moving the goal posts and limiting project investments. Rather than recurrently changing baselines as established in the bill, producers and investors need a static baseline to make production and investment decisions. USDA should be charged with determining the normal activity baseline for each offset project type using a historical or temporal baseline. Once USDA sets that baseline, offset projects can be judged against the baseline to determine whether a proposed action is additional vis-à-vis the temporal baseline. Such a baseline system will ensure certainty to producers (offset providers) and buyers.

7. **Global Implementation of Climate Change Legislation.** It is critical that the United States negotiates quickly a comprehensive implementation of GHG reductions around the world. Although we support the concept of cap-and-trade we remain concerned about the potential costs to the economy from unilateral action by the United States. There are a number of important agricultural exporters around the world that could gain competitive advantage if careful consideration is not given to the application of these reductions throughout the world.
-

These are the dairy industry's top recommendations for fully realizing the ag offset potential in the climate change legislation. We urge this committee to take on the role of champion for the agriculture industry in this matter as it has so often in other ag-related legislation. Our industry is concerned that should this bill pass through the Senate without these important corrections, there will not be a workable offsets title for America's livestock and farming sectors.

We cannot emphasize enough how important it is for this committee to make their stamp on the legislation that will come out of the Senate Environment and Public Works Committee. There are some who would advise standing on the sidelines and opposing this effort entirely. We believe that this is a huge risk for the livestock and row crop producers of America and we see great opportunities for our industry with properly crated legislation.

We urge this committee to proactively engage in drafting the Senate version of climate change bill better for agriculture.



QUESTIONS AND ANSWERS

SEPTEMBER 9, 2009

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Andy Beckstoffer
 September 9, 2009

Chairman Tom Harkin

You mentioned this briefly in your written testimony, but I want to spend a little bit more time discussing the impact that climate change is already having on your crops. I think this is an important topic to address because it illustrates the fact that there is a cost to doing nothing when it comes to climate change. For example, you mentioned more heat spikes, higher nighttime temperatures, and new pests and diseases as challenges that are beginning to emerge for your industry.

Even if we do not yet fully understand how all of these things will impact your business as a winegrape grower, surely these are challenges that concern you.

1. As a winegrape producer with over 30 years of experience in agriculture, could you talk a bit more about the business risks that climate change presents to your operation now and in the future?

On page five of my testimony I discuss more frequent heat spikes to which we have adjusted by installing trellises that we can alter on short notice to deal with heat spikes. We can adapt with proper viticultural practices at considerable expense, but it is necessary to maintain the quality of our premium winegrapes. There have been limited studies to assist the wine community in understanding the potential impacts of climate change to the quality and productivity of winegrape vineyards. However, the data we collect from vintage to vintage shows that we can adapt and that the maximum temperatures haven't changed so much – but that the minimum temperatures have risen, and that is something for which we must continually make adjustment. It is the extreme heat incidents and temperature changes, not the averages, that represent the most risk.

There is no doubt in my mind that much more needs to be done to identify suitable rootstocks and conduct new rootstock breeding programs to facilitate our adaptation. Of course, that is a years long – if not decades long – process and one that must be conducted in the context of changing consumer taste profiles and expectations. There is a five-year delay from the time I plant a vineyard to the time it reaches the consumer in a bottle. North Coast development costs for a new vineyard run from \$25,000 to \$40,000. Our capital investment is made for at least a 25 year period. That is why we invest so heavily in cutting-edge viticultural practices to adapt to things like changing temperatures.

Irrigation is critical to adaptation. The lower snow pack forecast by the experts and changing rainfall patterns present a very real risk to our businesses. Our quality, our productivity, and our profitability are dependent upon adequate water which we manage precisely with the most advanced technology in plant monitoring and water application.

The California Sustainable Winegrowing Program is an integrated whole farm approach to decision making that helps participants better understand and evaluate the trade-offs and impacts of each practice. It is an important tool for helping us adapt to changing resource and regulatory concerns.

The uncertainties presented by climate change and the scarce allocation of resources like water underscore the most important investment government can make: funding agricultural research and extension to assure that farmers and ranchers have the ability to continue adapting to meet the food and fiber needs of the world's rapidly expanding population.

2. Do you have any suggestions on how we could better educate farmers in other parts of the country about the implications to their livelihoods if nothing is done to address climate change over the decades to come?

Senator, this is surely not my area of expertise! However, the Committee might consider conducting field hearings in different regions of the country. It should also conduct hearings for researchers and extension personnel to provide information about the potential impacts of climate change to farmer and rancher livelihoods.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

While considerable research and demonstration of the advantages of no-till and minimum tillage practices has been done, not nearly enough research has been done to quantify the benefits of other practices and document their value as measurable, verifiable carbon and GHG offsets. Just a few of the ag practices that have the potential to produce significant offsets include cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

This is why it is critical that USDA with its technical and scientific expertise of agricultural and farming practices have the primary role in developing a GHG reduction or sequestration parameters for carbon offset protocols.

We plant our vineyards for an economic life of 20 years. Unless we are given credit for past and ongoing carbon sequestration, this legislation is of very little value to winegrape growers.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Farmers and ranchers must not be put at a competitive disadvantage in international trade. California winegrape growers face vigorous competition from other wine producing countries with lower costs of production.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

Those practices for which research has already been completed and protocols approved are planting trees (forestry) and conservation tillage. Therefore they are best positioned for measurable and verifiable offset credits. There is great potential for other ag practices to produce significant offsets and other environmental benefits from cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

It is very important that winegrapes and other perennial crops be given credit for carbon sequestration of past and continuing practices. We plant our vineyards for an economic life of 20 years. Thus, if credit is given only for new plantings, the legislation would be of little help to winegrape growers.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Domestic offsets should not be capped.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Luke Brubaker
September 9, 2009

Chairman Tom Harkin

In your testimony you mentioned being able to sell carbon credits for reducing greenhouse gas emissions through the use of your digester.

1) Can you tell us more about the economics of that project, please?

a. What was the total project cost and what is the annual income.

- Total project cost was \$1.25 million dollars.
- This year's income will be approximately \$200,000.00 for the sale of electric.

We derive a savings of approximately \$40,000 as a result of not needing to buy bedding for the cows. We separate the solids from the liquid and use it to bed the cows instead of buying wood shavings or saw dust.

We sell separated solids to other farmers. \$10,000 was derived from the sale of solids.

Sale of credits sold: about one-half sold for 20 years. What we sold equals over \$100,000 which when invested for 20 years approximately doubles the money.

b. How many credits does your system generate, how do you sell the credits, and at what price?

- KW = tons of carbon to sell taken out of the air.
- Sold to a trading company.
- The market fluctuates.
- We sold at a good time--\$3.00 to \$4.00 a ton.
- I believe the market is a lot less now.

- c. How does the income from the credits compare with the income from selling the electricity?
- A lot less for the safe of credits than sale of electricity.
 - With a good cap and trade bill, it could mean a lot more money for the credits.

Senator Pat Roberts

- 1) How many head of cattle does it take to make a methane/manure digester functional and economical?
 - A good number would be 500 head or more.
- 2) What is the annual operation and maintenance cost for a methane digester?
 - \$10,000 to \$25,000; this depends on the amount of repairs.
- 3) Does the functionality of a digester change with head count, feed content, or seasonal change? If so, how does this affect normal day to day operations and management ability?
 - Yes. In the summer, if there is more water in the manure, because of cooling the cows, it takes more volume of manure to make the same amount of electricity.
 - Adding other food products make extra electricity.
 - A little more setup on the computer system to add other feed or food by-products.
- 4) Do you believe a digester would work on a cow-calf operation, feeder cattle operation or for a small feedlot?
 - If the manure is in a liquid form that the manure can flow, it could work.
 - Getting the manure to the digester as quickly as possible is the key before it loses the gases into the air.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
 - I believe agriculture has a great opportunity with the use of conservation practices: no-till, cover crops, and methane digesters.
 - The bill must more than offset any higher cost the farmer would incur.
 - I do believe planting trees and forest management would be a big part of the program, but I am not sure if would benefit most of agriculture.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.
 - I think your statement is very true.
 - If a bill is written wrong, it would be devastating to agriculture.
 - Imports may have a tendency to come into the country like fertilizer, dairy products and fruits, etc. if U.S. products are priced out of the market.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
 - In order: Planting trees, grasslands, no-till, cover crops, and methane digesters.
- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?
 - My farming operation put forth a significant capital investment in order to install the methane digester, which is a clean, efficient and an American source of renewable energy. I do not think it would be a good idea to cap domestic agricultural off-sets as proposed in the U.S. House version of the Climate Change legislation. There does not seem to be any sound policy rationale for placing a cap on such offsets, like those produced by my farming operation, that supply clean and efficient domestic energy and provide a valuable environmental benefit.

There may, however, be appropriate reasons for considering caps on international offsets for two reasons. First, many people argue that this legislation would drive American jobs off-shore. Without a cap on foreign off-sets, the purchase of such off-sets may also be driven off-shore, where there is little regulation and these off-sets would be feasibly cheaper than the same type of off-sets in the United States. Secondly, I would call it bad policy to offer the same countries the ability to sell "off-sets" when they have not adopted any caps on emissions. Such an approach would truly put the American farmer and businessman at a competitive disadvantage.

My recommendation to the Committee would be to allow international off-sets to be considered for purchase, only after a certain level of domestic off-sets have been utilized, set at a sufficiently high level to assure that all agricultural producers have the opportunity to benefit from such a program. This approach shows a true investment in the American economy (at this much needed time) and does not totally create a trade barrier with other nations.

- 3) As you know, many dairy and hog producers are going through a historic economic downturn in their respective industries. Several hog and dairy producers are tens of thousands of dollars of equity with each passing week. Any analysis that shows a positive impact on these producers assumes that operations of a certain size will install an anaerobic digester to benefit from carbon offsets. Considering the high costs of this equipment and the fact that the climate change legislation would start in 2012, do you believe that most producers would be able to finance this type of equipment in the next 12 to 18 months?

- Thank you for being aware of this. I am a dairy farmer and I know.
- I don't have any analysis that shows a positive impact.
- There is a very easy way to capture carbon offsets.
- You can cover any size manure pit and lagoon and flare off the gases.
- if there is a good price for credit; this would be a very reasonable way to capture credits.
- Maybe a small grant to help cover lagoons would help in these low commodity prices for hog and dairy farmers.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Chairman Gary Gensler
 September 9, 2009

Chairman Tom Harkin

- 1) As Congress considers reforms of the Commodity Exchange Act, what modifications would be necessary to provide the authority for CFTC to effectively regulate trading in both the cash and futures markets for emission allowances and offsets?

Senator John Thune

- 1) H.R. 2454 allows third parties, such as investment banks or foreign nations to participate in the carbon market. In other words, third parties that are not directly associated with carbon offsets would be able to purchase these credits on an exchange. Does this leave the carbon market open to undue influence or manipulation? Under this scenario, would a third party or a group of third parties be able to drive up the price of carbon by purchasing large amounts of carbon allowances or available carbon credits?

What role will speculators play in the carbon market? How will you define a speculator? How will you define excessive speculation?

- 2) As you know, the House cap and trade bill gives jurisdiction over the carbon-based derivatives to the CFTC, with the Federal Energy Regulatory Commission overseeing cash transactions in the allowances themselves. Standalone legislation has been introduced in the Senate that would give the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market. Would you compare and contrast the benefits or drawbacks of giving the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market?
- 3) We have heard estimates that the future carbon market under a mandatory cap-and-trade proposals will total several billions of dollars up to two trillion – according to CFTC Commissioner Bart Chilton. What is your estimate for the carbon futures market? What is your estimate for the carbon cash market? What is the size of these markets today?
- 4) As you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

- 5) How will the CFTC work with EPA to determine when or if carbon allowance reserves should be tapped? Are these reserve thresholds adequate to keep carbon costs steady?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System

Questions for the record

Mr. Joseph R. Glace

September 9, 2009

Chairman Tom Harkin

- 1) Can you break down the costs of the over-the-counter transaction for me? How much does it cost to conduct business on exchange versus off-exchange? What are the indirect costs associated with wider bid-ask spreads in the over-the counter markets compared to exchange trading? How much more would electricity cost your customers if you could only hedge on regulated markets with stricter margin and capital requirements?

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?
- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

Senator John Thune

- 1) Can you provide an example of why two market participants would need to use the Over the Counter (OTC) market for a transaction in the carbon market place?

In your testimony, you mentioned that forcing these unique transactions onto an exchange would dramatically drive up costs. Could you provide this committee with a better perception of why this requirement would increase costs, and how much would costs increase on account of such a requirement? With regards to these transactions, what specific types of information should be reported to ensure transparency while still maintaining the confidential information of the emitter and trader?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Dr. Dave Miller
September 9, 2009

Chairman Tom Harkin

- 1) In your written testimony, you discussed the challenges of establishing standards for offsets. You also mentioned the costs associated with assuring the value of offset activity and that the cost could become prohibitive. Given your discussion of complicated design protocols and uncertainty about valuing offsets, would you support discounts on offsets as a mechanism to address some of the valuation and verification problems inherent in an offset program? If so, should the offsets be discounted by a standard percentage or should the discount reflect expected leakage or nonperformance?

Senator Chuck Grassley

- 1) Do you believe that it is possible for the average farmer, in Iowa or elsewhere, to recover his increased input costs, in terms of higher fuel and fertilizer prices for example, that would be caused by a cap and trade system like in the Waxman-Markey Bill, by selling offsets?
- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
- 3) Of the sources of ag offsets, one of the most frequently mentioned is shifting to no-till, but the EPA analysis admits that "agricultural soil sequestration does not show significant supply." Another option is reducing fertilizer use, but the EPA model showed what any farmer could tell you that this results in a decline in yields. Another often discussed offset possibility would be for farmers to install an anaerobic digester, but those can cost hundreds of thousands of dollars and a federal AgSTAR program report found that anaerobic digesters are feasible for only what amounts to about 1 percent of Iowa farms. How would a typical farmer in Iowa be able to receive any significant benefit from selling carbon offsets?
- 4) In order for farmers to get paid for sequestering carbon dioxide in the soil, they would have to switch to no-till, but many farmers have already been using no-till for many years where it's possible to do so. Any farmer that was using no-till before the date we establish in law would not be eligible for payments. This could result in two neighboring

farmers using no-till where the one who had switched over years ago would not see a dime and the Johnny-come-lately would receive a check for doing the exact same thing that his neighbor had been doing all along. This would surely strike most farmers as fundamentally unfair. What can be done to address the fairness issue?

- 5) We've heard a lot about opportunities for farmers to sell offsets, but it's not always clear how exactly that would work in practice. Since the farmer would actually be selling on a carbon market and offsets would need to be verified and registered, I imagine the process would be a little different from signing up for a FSA program for instance. Could you walk me through the process a farmer would undertake to receive payment of an offset through let's say USDA, for sake of discussion?
- 6) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?
- 7) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Timothy Profeta
September 9, 2009

Chairman Tom Harkin

- 1) You said in your testimony that there is a fundamental trade-off between “Mitigating systemic risk and creating additional cost of posting margin.” It seems that a lot of our legislative choices come down to this type of calculation, over-the-counter transactions where businesses don’t need to put up a lot of cash to do business and exchanges where they expect you to put up some money to back your bets. But if the regulatory system does not deal effectively with systemic risk, such as that posed by OTC trading, are there not costs to that? I’m referring to the costs of using intermediaries like dealer-banks, or volatility, or economic downturns, or taxpayer-funded bailouts.

There are costs embedded in over-the-counter instruments. Cost comparisons typically compare the cash required to post margin for an exchange trade with the fact that OTC contracts may allow purchasers to pledge physical assets as collateral rather than posting cash margin or perhaps not require any collateral at all. By not requiring cash margin, OTC instruments may allow entities to use their cash flows for other purposes. OTC instruments may have transaction costs embedded in the price of the contracts, however.

Events over the past year make it clear that large markets failures can affect broad sections of the economy. Excessive risk-taking in the credit default swap markets, for example, has resulted in significant costs to society, not only through taxpayer-funded bailouts, but also through restricted credit markets and significant loss of value across securities markets. In terms of a carbon market, the cost of large scale market failures could include undermining the nation’s approach to addressing climate change. Congress can take steps to avoid these types of failures in the carbon market by ensuring that market participants properly capitalize financial risks. Reduced leverage, larger capital requirements and prudent margin requirements are all necessary parts of the solution. However, the elimination of regulatory arbitrage is also a key to a stable market, with regulators having sufficient information to evaluate the risks to which market participants are exposed.

As Congress moves forward with climate change legislation, it will have to balance the risks and costs posed by OTC instruments with the flexibility and lower cash requirements that these instruments provide for market participants.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

The evolution of the OTC market over the last ten years is highlighted by the increase in "exotic" derivatives. Plain-vanilla OTC derivatives, such as interest-rate swaps, have been around for approximately thirty years.

There are two arguments for how OTC instruments keep costs low. The first argument is that OTC contracts provide entities with the flexibility to determine the most cost effective means of hedging risk. Entities may choose OTC instruments because the instruments are not available on exchanges, such as long-dated contracts, or they need an instrument that is specifically tailored to their business needs. The second argument is that OTC contracts may allow companies to avoid tying up their cash reserves by posting margin. Exchange-traded products require initial margin and variation margin posted on a daily basis in cash (or near cash, such as government securities). A customized OTC contract can have specific parameters written into it that allows changes in the frequency for variation margin to be posted (i.e., not daily). OTC contracts may also allow companies to assign non-cash collateral as initial margin or, in some circumstances, not post collateral at all.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

There are different levels of transparency in the current commodities markets regulated by the CFTC, depending on the type of commodity and where the commodity trades. While broader market reforms currently under consideration may increase transparency in commodities markets, these efforts are still underway and it is impossible to predict what the final requirements will be. Because Congress would be creating the carbon market *de novo*, the legislation could ensure that the market regulator has jurisdiction over the entire marketplace and can track all transactions involving carbon allowances or associated derivative instruments, regardless of who is involved in the trade and where the trades occur.

Unlike traditional commodities, emission allowances issued pursuant to federal climate legislation will likely have unique serial numbers, allowing regulators to track ownership of the allowances with the proper reporting requirements. The legislation or implementing regulations could achieve transparency in the derivatives markets by requiring reporting from exchanges,

clearing organizations, trade repositories, and intermediaries such as brokers and dealers. If over-the-counter instruments are allowed in the carbon market, the rules could also require reporting directly to the regulator if the transactions are not cleared or reported to trade repositories.

Senator John Thune

- 1) Relative to other commodity markets, how large will the carbon market be? Is it possible to establish unique regulations that will result in efficiency and transparency of such a large carbon market within two years?

The Clean Energy Jobs and American Power Act would create a substantial new carbon market but would not be larger than many existing commodity markets. Economic modeling conducted by the U.S. EPA suggests that the price of emission allowances would likely be around \$13 per allowance in 2015. Just over five billion allowances would be issued that year, resulting in an allowance market worth approximately \$65 billion. As a general rule, commodities trade between 6 and 9 times their underlying value in the futures market. This suggests that the derivatives markets could exceed \$390 billion in the early years. In comparison, the value of global crude oil markets traded on the Intercontinental Exchange (ICE) and NYMEX exceeded \$17 trillion in 2008. Global futures for cotton and sugar trading on ICE reached \$154 billion and \$543 billion in 2008, respectively.

It is possible to create an efficient and transparent regulatory system to oversee trading in the carbon market. The major legislative proposals for regulating the carbon market, including the American Clean Energy and Security Act that passed the U.S. House of Representatives in June of this year and the Carbon Market Oversight Act of 2009, introduced by Senators Diane Feinstein and Olympia Snowe, are founded upon the existing CFTC regulatory model. Both bills adopt many aspects of the Commodity Exchange Act and add specific requirements to address the unique aspects of the carbon market, including some best practices from existing securities regulations. The CFTC would build upon its existing expertise rather than creating an entirely new regulatory system.

- 2) As you stated in your testimony, a cap and trade scheme will create two markets, a cash market that will trade allowances from the current year, and a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances. Should both markets be regulated by the CFTC? If so, what are the potential pitfalls of splitting the regulatory responsibility with another agency? If not, what additional resources will the CFTC need to carry out this responsibility within the next couple of years?

The CFTC is well-positioned to regulate both the spot and derivative markets for carbon allowances. The cash and derivative markets will be highly correlated and it would be most efficient to have one regulator with its eyes on the entire carbon market complex, including OTC derivatives. The recent failures in the credit default swaps markets highlight the problems caused by relying on multiple regulators to oversee various aspects of the same market.

Additional pitfalls for splitting regulatory authority include the potential for turf wars and a history of poor cooperation between various government agencies.

Generally, the CFIC will need sufficient resources to oversee the carbon market; the key to good regulation is a well-funded and vigilant regulator. I am not in a position to estimate the additional resources that will be necessary. Chairman Gensler and his staff may be able to provide you with a specific answer.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Frank Rehermann
 September 9, 2009

Chairman Tom Harkin

I am concerned that global warming's impacts – longer droughts and heat waves, increased pests, and increased disease may well be the biggest threat to farmers' abilities to make a profit.

- 1) Have you considered the potential drawbacks of inaction? How global warming will directly impact your industry?

The USA Rice Federation does not oppose responsible efforts to curb greenhouse gas emissions or climate change, including approaches such as increased use of renewable energy sources, nuclear energy, conservation, enhanced efficiencies, and other approaches that would not harm the U.S. economy or cost American jobs. We are deeply concerned that the cap and trade bill emanating from the House and similar approaches would be especially harmful to family farm operations like mine. The pending cap and trade proposal would substantially increase production costs and lower net income, threatening the economic viability of the farm. Meanwhile, I have little confidence that our trading partners will bind their farms and industry to equally rigorous emission reduction requirements, if any at all.

Senator Pat Roberts

- 1) You mention the AFPC study by Texas A&M. The representative rice farms experience lower average annual net cash income and at the same time an increase in annual costs. How does this study affect a producer's relationship with his or her lender? Credit is certainly tight already. Do you expect it to become even tighter if cap and trade legislation were to pass? How does this affect beginning farmers and ranchers?

The impact of pending cap and trade legislation ranges from even tighter margins for some to negative cash flow for others. The effect is to erode a producer's equity position, something lenders look unfavorably on when making lending decisions. For producers in the latter end of the range and especially for small and beginning farmers, the impact of cap and trade legislation could prove decisive in a lender's decision, while producers in the former range are on the bubble. This is why, in our testimony, we urge Congress to authorize the Commodity Credit Corporation to cover any increased production costs.

- 2) If H.R. 2454 were to become law, how would a rice farmer overcome the higher input costs? Would one 'good' year be enough to cover current costs plus addition direct and indirect costs associated with climate change?

We are concerned that some producers simply would not be able to overcome the higher costs and our concern is predicated on a normal or good production year as yield fluctuation from year to year is not as great as it is with respect to many other crops. Production costs and price are principle determinants on how a rice producer fares in a given crop year and the first factor is going to be greatly influenced by this legislation. Note that this is only the production side of the equation. Unlike most other commodities, rice must ordinarily be processed (i.e. milled) before it can be widely marketed in commerce, meaning there will also be increased costs borne by the producer in putting the commodity in the form necessary to market the crop. In fact, generally, rice farmers participating in cooperatives can expect to face a whole other hit in the form of lower patronage refunds, or dividends, on account of the cooperative's increased cost of doing business. And, all of this is predicated on the uncapped treatment of the agricultural sector precluding EPA-imposed performance standards or other prescriptions that the Agency could still impose under other provisions of the bill or the underlying Clean Air Act. There is no effective exemption for production agriculture and necessary processing is not even covered under the definition of agriculture sector. If cap and trade is to go forward, at minimum, there needs to be a clear exemption for agriculture production, including necessary processing.

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

Senator, as a farmer, you can appreciate that if there is a clear and responsible way to cut production costs, a farmer will do it. Few stones have been left unturned in this respect. You also know that we are price takers, so we cannot increase the price on the market. One way to offset increased costs associated with cap and trade is through the sequestration or reduction of carbon. However, as I noted in my written and verbal testimony, today that is not an economically viable and proven option for rice farmers. The only choice we are left with is to absorb the increased costs and hope to still make ends meet.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

In rice, we see no economically viable opportunity at present to avail ourselves of the offset program being discussed. We are working to develop some possibilities but we are simply not there yet. The primary objection to the forestation option is that farmers and ranchers are not foresters. Beyond that, even if we were to attempt to go that route, it would seem to me that it would involve an enormous upfront investment without the possibility for any real pay off till years down the road when the trees mature. This is a possibility for large pulp and paper companies but not to farm and ranch families.

- 3) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator, we appreciate your leadership in rejecting what was on the table in the Doha Round negotiations late last year because the agreement meant deep and, in our estimation, unsustainable cuts to U.S. domestic support in exchange for what amounts to illusory concessions from our trading partners. We have no doubt that a similar tact is being taken with respect to global climate change and the curbing of greenhouse gas emissions, as evidenced by recent media reports of comments made by Indian officials. The combination of Doha Round and climate change legislation could very well result in the kind of severe hemorrhaging of American agriculture and the jobs that go with it that we experienced in the manufacturing sector earlier this decade. So, we appreciate the tough stance that you, Chairwoman Lincoln, Ranking Member Chambliss, and others have taken in both regards.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

As noted in our response to earlier questions, we are unaware of any proven viable opportunities for rice producers to generate and market offsets in the near future.

In a world of 6.7 billion hungry people, the great majority of whom do not have the means or disposable incomes that we Americans do, we strongly reject the notion that there is greater societal or global benefit to planting trees on our rice-fields than farming them. Ours are some of the most productive acres in the world, and we would rather continue to pursue the more noble purpose of feeding the world as long as we can stay in business.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Although rice is unable to participate in the agricultural offset program, we believe that U.S. agricultural offset opportunities should not be capped. With respect to international offsets, among other things, it would seem that there would be enforcement issues that could undermine the integrity of the program, so the larger the international program the greater the uncertainty may be relative to the program's effectiveness. However, since

rice farmers are not able to effectively participate in the offset program, we have not closely examined the implications of capping international offsets. We believe the program should be structured such as to increase demand for U.S. offsets and therefore increase the value of such offsets, rather than disadvantage U.S. offsets relative to those in the international market.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System

Questions for the record
 Ms. Julie Winkler
 September 9, 2009

Chairman Tom Harkin

- 1) One of the more frequent complaints we hear about central counterparty clearing is that the costs associated with clearing are too expensive and that it would tie up capital that could be better invested. Could CME Clearport accept illiquid assets such as real estate or stocks and count that towards margin or capital requirements? Could you net cash and futures positions in a market where the cash and futures transactions are executed on the same platform? What other options are there to mitigate cost concerns of margin and capital requirements without compromising the integrity of the clearinghouse?

ANSWER: *Collateral that is readily convertible to cash is an essential element of the safety of a central counterparty clearing system and the only means to avoid the creation of systemic risk. The central counterparty (CCP) must hold sufficient liquid collateral to enable it to immediately meet the obligations of a clearing member—customer which defaults, since the CCP must immediately fulfill the obligations of the defaulting clearing member to each counterparty. There is no way to do this, without adding debt to the system, if the clearing house is holding illiquid assets, such as real estate, as collateral. The Green Exchange Venture currently uses CME Clearing as its CCP. CME Clearing has never experienced a default in its 110 year-plus history. CME Clearing does accept readily marketable securities, but discounts their value in a manner appropriate to recognize any likely illiquidity at the time that they must be sold to cover a loss.*

CCP's are not in the business of lending to customers. That would simply magnify the risk of operating a CCP and defeat the purpose of centralized clearing. If a customer with real estate assets needs to collateralize a cleared position, she may secure a loan from a bank and use the proceeds of the loan to purchase interest bearing securities, which may be used to collateralize her obligations to the CCP.

It is possible, in certain circumstances, to use a physical allowance to collateralize a derivative position. For example, a trader who is short an allowance futures contract may be able to collateralize his position, in whole or in part, with allowances of similar maturity.

- 2) If legislation establishing greenhouse gas emission allowances and offsets, required that all trading of the allowances, offsets and their derivatives take place on regulated exchanges, and if there is sufficient market interest for allowances 5, 10 or even 20 years in the future, would an exchange be able to offer futures contracts of longer duration? What are the practical considerations that would affect the decision to develop longer-term contracts?

ANSWER: Some futures contracts are long-dated and have adequate liquidity. For example, NYMEX's Natural Gas futures contract extends out 12 years and CME's Eurodollar futures contract extends out 10 years. However, exchange traded derivative contracts of these durations are the exception, not the rule. Price integrity is the critical component to offering long-dated futures contracts as the clearinghouse must be able to determine adequate performance bond coverage for the contracts and protect against default. Each contract month listed in a long-dated futures contract that has open interest will require a daily settlement process to employ the daily mark-to-market functions of the CCP. If legislation created a cap-and-trade program in which allowances were used for compliance over 5, 10, or 20 year periods then long-dated emissions contracts could be designed and offered by exchanges such as the Green Exchange Venture.

However, there could be challenges in generating sufficient liquidity for the long-dated instruments on an exchange. Cap-and-trade participants may be focused on shorter-term compliance obligations involving near-term compliance deadlines that can be satisfied using actual allowances and offset credits that are in their possession or in circulation. The cap-and-trade program could address this by ensuring that there are longer-term vintages of allowances distributed and in circulation. This would provide market participants with a greater certainty about the physical supply of allowances in future years. This may result in greater hedging interest and trading activity in 5, 10 or 20 year carbon futures contracts. Without such certainty of the physical supply of allowances in future years, it is unlikely that adequate liquidity will exist for long-dated exchange-traded contracts.

- 3) I see you are opposed to a transaction fee, such as we've seen in the House-passed climate change legislation. If we were to propose a user fee on these transactions to fund regulatory agencies, what would be the best way to structure it – for example, per exchange member, per transaction, per month, per year?

ANSWER: Funding for market oversight should be generated from more appropriate sources. Most cap-and-trade legislative proposals contemplate an auction for some portion of the allowances. For example, it would take less than one percent of the expected revenues from the auction proposed in the House's American Clean Energy Security Act to fund CFTC's current budget. By tying the funding of oversight resources to allowance auction revenues rather than exchange transactions, all relevant agencies (e.g., USDA, CFTC, EPA) will have resources for all of the elements that are necessary for effective emissions market oversight.

Exchange users pay trading fees which are used to fund exchange operations and the exchange's self regulatory oversight to ensure and compliance with statutory and regulatory requirements. Any additional user fee, based on transactions or targeted at only members of exchanges, will add transaction costs and make less or unregulated trading venues more attractive compared to regulated exchanges. This will impair liquidity and defeat efforts to encourage transparent, regulated trading markets.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

ANSWER: First, there seems to be a mistaken impression regarding the length of the existence of OTC contracts. Such contracts have actually been utilized for more than 20 years in energy commodities. Second, the reason such contracts came into existence is precisely because they provided innovative, lower costs ways to finance investments; indeed, in some cases, they enabled projects to get financed that otherwise could not have gotten financed at all. Furthermore, they will be the most vital in the early days of any new industry or new industry phase, which will clearly be the scenario in place upon passage of emissions control legislation. This is because the sector will essentially be "inventing" itself--that is, ramping up from a state of de minimis investment in demonstration projects to a full scale commitment to transform the entire societal energy infrastructure. No one yet knows how this will most efficiently be accomplished, so there will be no way to accurately standardize the necessary transactions.

As was stated in my written testimony, the OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies. If such OTC contracts are required to efficiently finance such projects, forcing all trading onto exchange-based platforms is likely to increase costs to utility customers.

Exchange cleared transactions require posting of liquid collateral; some entities may be able to secure more flexible terms for collateralizing their obligations in the OTC market. For example, a customer in the OTC market may be allowed to collateralize its obligations on an OTC contract by granting a lien on a physical asset. The ability to collateralize obligations to counterparties by means of liens on physical assets may

benefit power producers or agricultural offset project developers. Lower financing costs for OTC hedging transactions may translate into lower power costs to consumers.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

ANSWER: We believe that greater transparency should be required of the OTC carbon market and that all carbon-related OTC positions should be reported to the CFTC. This reporting combined with the high level of transparency available through the Green Exchange Venture will provide the additional transparency that is needed for oversight of a U.S. carbon market.

As was stated in my written testimony, CME Group will provide the market and trade surveillance services to the Green Exchange Venture. CME's highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Green Exchange Venture also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. On behalf of the Green Exchange Venture, CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Fred Yoder
September 9, 2009

Chairman Tom Harkin

You've indicated that you think those farmers who have already engaged in practices that reduce greenhouse gas emissions should be rewarded for their early actions.

- 1) Let's take the example of a corn farmer who started to use no-till practices in 2006. How should those practices over the past few years be treated in global warming legislation? And, does it make a difference whether the farmer sold carbon sequestration credits derived from those practices on the Chicago Climate Exchange?

Senator Pat Roberts

- 1) In your testimony, you mention "economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program." Since analysis shows both significant agriculture production cost increases and increased commodity prices due to a reduction in farm land acreage even with an offset program, won't consumers still feel the effects of these higher costs and prices?

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?
- 2) You mention that treatment of early actors, especially those who have adopted conservation tillage practices prior to 2001, should not be penalized in the carbon offset program developed. Do you have recommendations on how to address this issue, in particular for the earliest adapters as you have highlighted?
- 3) EPA numbers suggest very high cost increases to use coal. Since the Corn Belt primarily uses coal to provide our energy needs, do you believe that fuel switching will occur? To which types of fuels? What does this mean for our rural communities?

- 4) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
- 5) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator John Thune

- 1) If under a cap and trade system, ag producers are asked to sign a long-term contract, but only receive benefits of carbon sequestration for a few years or until the soil is saturated with carbon, do you think your members are likely to participate?
- 2) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
- 3) Do you believe fertilizer prices will increase under a cap and trade system? If so, how high may fertilizer prices increase? Do you believe we will have a greater reliance on foreign sources of fertilizer?

In the later years of the House-passed cap and trade bill, "energy intensive trade exposed" industries including the fertilizer industry, no longer receive free allowances. What impact will that have on the fertilizer industry and the price of fertilizer? If most early acres of conservation tillage are saturated with carbon at this point, what impact will these two scenarios have on the cost-benefit analysis for feed grain farmers in the Midwest?

- 4) How should Congress treat the early actors of conservation practices? For example, South Dakota already had 2.8 million acres in no-till, which would not receive credit under the House-passed climate change bill since these acres were in no-till before 2001. Should these producers be able to participate in the carbon market? If so, how should these acres be treated?
- 5) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Andy Beckstoffer
 September 9, 2009

Chairman Tom Harkin

You mentioned this briefly in your written testimony, but I want to spend a little bit more time discussing the impact that climate change is already having on your crops. I think this is an important topic to address because it illustrates the fact that there is a cost to doing nothing when it comes to climate change. For example, you mentioned more heat spikes, higher nighttime temperatures, and new pests and diseases as challenges that are beginning to emerge for your industry.

Even if we do not yet fully understand how all of these things will impact your business as a winegrape grower, surely these are challenges that concern you.

1. As a winegrape producer with over 30 years of experience in agriculture, could you talk a bit more about the business risks that climate change presents to your operation now and in the future?

On page five of my testimony I discuss more frequent heat spikes to which we have adjusted by installing trellises that we can alter on short notice to deal with heat spikes. We can adapt with proper viticultural practices at considerable expense, but it is necessary to maintain the quality of our premium winegrapes. There have been limited studies to assist the wine community in understanding the potential impacts of climate change to the quality and productivity of winegrape vineyards. However, the data we collect from vintage to vintage shows that we can adapt and that the maximum temperatures haven't changed so much – but that the minimum temperatures have risen, and that is something for which we must continually make adjustment. It is the extreme heat incidents and temperature changes, not the averages, that represent the most risk.

There is no doubt in my mind that much more needs to be done to identify suitable rootstocks and conduct new rootstock breeding programs to facilitate our adaptation. Of course, that is a years long – if not decades long – process and one that must be conducted in the context of changing consumer taste profiles and expectations. There is a five-year delay from the time I plant a vineyard to the time it reaches the consumer in a bottle. North Coast development costs for a new vineyard run from \$25,000 to \$40,000. Our capital investment is made for at least a 25 year period. That is why we invest so heavily in cutting-edge viticultural practices to adapt to things like changing temperatures.

Irrigation is critical to adaptation. The lower snow pack forecast by the experts and changing rainfall patterns present a very real risk to our businesses. Our quality, our productivity, and our profitability are dependent upon adequate water which we manage precisely with the most advanced technology in plant monitoring and water application.

The California Sustainable Winegrowing Program is an integrated whole farm approach to decision making that helps participants better understand and evaluate the trade-offs and impacts of each practice. It is an important tool for helping us adapt to changing resource and regulatory concerns.

The uncertainties presented by climate change and the scarce allocation of resources like water underscore the most important investment government can make: funding agricultural research and extension to assure that farmers and ranchers have the ability to continue adapting to meet the food and fiber needs of the world's rapidly expanding population.

2. Do you have any suggestions on how we could better educate farmers in other parts of the country about the implications to their livelihoods if nothing is done to address climate change over the decades to come?

Senator, this is surely not my area of expertise! However, the Committee might consider conducting field hearings in different regions of the country. It should also conduct hearings for researchers and extension personnel to provide information about the potential impacts of climate change to farmer and rancher livelihoods.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

While considerable research and demonstration of the advantages of no-till and minimum tillage practices has been done, not nearly enough research has been done to quantify the benefits of other practices and document their value as measurable, verifiable carbon and GHG offsets. Just a few of the ag practices that have the potential to produce significant offsets include cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops -- vineyards; orchards; hay; and dedicated fuel crops.

This is why it is critical that USDA with its technical and scientific expertise of agricultural and farming practices have the primary role in developing ag GHG reduction or sequestration parameters for carbon offset protocols.

We plant our vineyards for an economic life of 20 years. Unless we are given credit for past and ongoing carbon sequestration, this legislation is of very little value to winegrape growers.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Farmers and ranchers must not be put at a competitive disadvantage in international trade. California winegrape growers face vigorous competition from other wine producing countries with lower costs of production.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

Those practices for which research has already been completed and protocols approved are planting trees (forestry) and conservation tillage. Therefore they are best positioned for measurable and verifiable offset credits. There is great potential for other ag practices to produce significant offsets and other environmental benefits from cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

It is very important that winegrapes and other perennial crops be given credit for carbon sequestration of past and continuing practices. We plant our vineyards for an economic life of 20 years. Thus, if credit is given only for new plantings, the legislation would be of little help to winegrape growers.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Domestic offsets should not be capped.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Luke Brubaker
September 9, 2009

Chairman Tom Harkin

In your testimony you mentioned being able to sell carbon credits for reducing greenhouse gas emissions through the use of your digester.

1) Can you tell us more about the economics of that project, please?

a. What was the total project cost and what is the annual income.

- Total project cost was \$1.25 million dollars.
- This year's income will be approximately \$200,000.00 for the sale of electric.

We derive a savings of approximately \$40,000 as a result of not needing to buy bedding for the cows. We separate the solids from the liquid and use it to bed the cows instead of buying wood shavings or saw dust.

We sell separated solids to other farmers. \$10,000 was derived from the sale of solids.

Sale of credits sold: about one-half sold for 20 years. What we sold equals over \$100,000 which when invested for 20 years approximately doubles the money.

b. How many credits does your system generate, how do you sell the credits, and at what price?

- KW = tons of carbon to sell taken out of the air.
- Sold to a trading company.
- The market fluctuates.
- We sold at a good time--\$3.00 to \$4.00 a ton.
- I believe the market is a lot less now.

- c. How does the income from the credits compare with the income from selling the electricity?
- A lot less for the sale of credits than sale of electricity.
 - With a good cap and trade bill, it could mean a lot more money for the credits.

Senator Pat Roberts

- 1) How many head of cattle does it take to make a methane/manure digester functional and economical?
 - A good number would be 500 head or more.
- 2) What is the annual operation and maintenance cost for a methane digester?
 - \$10,000 to \$25,000; this depends on the amount of repairs.
- 3) Does the functionality of a digester change with head count, feed content, or seasonal change? If so, how does this affect normal day to day operations and management ability?
 - Yes. In the summer, if there is more water in the manure, because of cooling the cows, it takes more volume of manure to make the same amount of electricity.
 - Adding other food products make extra electricity.
 - A little more setup on the computer system to add other feed or food by-products.
- 4) Do you believe a digester would work on a cow-calf operation, feeder cattle operation or for a small feedlot?
 - If the manure is in a liquid form that the manure can flow, it could work.
 - Getting the manure to the digester as quickly as possible is the key before it loses the gases into the air.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
 - I believe agriculture has a great opportunity with the use of conservation practices: no-till, cover crops, and methane digesters.
 - The bill must more than offset any higher cost the farmer would incur.
 - I do believe planting trees and forest management would be a big part of the program, but I am not sure if would benefit most of agriculture.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement; will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.
 - I think your statement is very true.
 - If a bill is written wrong, it would be devastating to agriculture.
 - Imports may have a tendency to come into the country like fertilizer, dairy products and fruits, etc. if U.S. products are priced out of the market.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
 - In order: Planting trees, grasslands, no-till, cover crops, and methane digesters.
- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?
 - My farming operation put forth a significant capital investment in order to install the methane digester, which is a clean, efficient and an American source of renewable energy. I do not think it would be a good idea to cap domestic agricultural off-sets as proposed in the U.S. House version of the Climate Change legislation. There does not seem to be any sound policy rationale for placing a cap on such offsets, like those produced by my farming operation, that supply clean and efficient domestic energy and provide a valuable environmental benefit.

There may, however, be appropriate reasons for considering caps on international offsets for two reasons. First, many people argue that this legislation would drive American jobs off-shore. Without a cap on foreign off-sets, the purchase of such off-sets may also be driven off-shore, where there is little regulation and these off-sets would be feasibly cheaper than the same type of off-sets in the United States. Secondly, I would call it bad policy to offer the same countries the ability to sell "off-sets" when they have not adopted any caps on emissions. Such an approach would truly put the American farmer and businessman at a competitive disadvantage.

My recommendation to the Committee would be to allow international off-sets to be considered for purchase, only after a certain level of domestic off-sets have been utilized, set at a sufficiently high level to assure that all agricultural producers have the opportunity to benefit from such a program. This approach shows a true investment in the American economy (at this much needed time) and does not totally create a trade barrier with other nations.

- 3) As you know, many dairy and hog producers are going through a historic economic downturn in their respective industries. Several hog and dairy producers are tens of thousands of dollars of equity with each passing week. Any analysis that shows a positive impact on these producers assumes that operations of a certain size will install an anaerobic digester to benefit from carbon offsets. Considering the high costs of this equipment and the fact that the climate change legislation would start in 2012, do you believe that most producers would be able to finance this type of equipment in the next 12 to 18 months?

- Thank you for being aware of this. I am a dairy farmer and I know.
- I don't have any analysis that shows a positive impact.
- There is a very easy way to capture carbon offsets.
- You can cover any size manure pit and lagoon and flare off the gases.
- if there is a good price for credit; this would be a very reasonable way to capture credits.
- Maybe a small grant to help cover lagoons would help in these low commodity prices for hog and dairy farmers.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Chairman Gary Gensler
September 9, 2009

Chairman Tom Harkin

- 1) As Congress considers reforms of the Commodity Exchange Act, what modifications would be necessary to provide the authority for CFTC to effectively regulate trading in both the cash and futures markets for emission allowances and offsets?
 - A. Currently, the CFTC has exclusive jurisdiction over futures contracts, options on futures contracts, and options for emission allowances and offsets traded on a Designated Contract Market (DCM) or Derivatives Transaction Execution Facility (DTEF). The CFTC has only limited enforcement authorities over cash market transactions.

If Congress chose to have the CFTC regulate cash market transactions in emission allowances and offsets, the Commodity Exchange Act (CEA) would need to be amended to create such authority.

Depending on whether contracts for emission allowances and offsets fit the definition of excluded or exempt commodity under the CEA, futures, options on futures, and options for allowances and offset could be conducted bilaterally and be largely excluded from the CFTC's authority. To avoid this, Congress would have to provide the CFTC with explicit authority over carbon emission allowance and offset swaps.

Senator John Thune

- 1) H.R. 2454 allows third parties, such as investment banks or foreign nations to participate in the carbon market. In other words, third parties that are not directly associated with carbon offsets would be able to purchase these credits on an exchange. Does this leave the carbon market open to undue influence or manipulation? Under this scenario, would a third party or a group of third parties be able to drive up the price of carbon by purchasing large amounts of carbon allowances or available carbon credits?

What role will speculators play in the carbon market? How will you define a speculator? How will you define excessive speculation?

A: A primary indicator of the ability to effect a manipulation of commodity markets is the ability to exert market power. Past enforcement cases brought by the CFTC have involved both speculators and commercial hedgers who accumulated and sought to exert

market power. Any party or groups of parties acting in concert could conceivably attempt to corner or squeeze a market independent of whether there are commercials or speculators.

The role that speculators will play in a carbon market will ultimately be dependent upon whether Congress enacts any changes to existing law. Under current law, speculators are free to participate in emissions derivative markets.

The CFTC has not defined what constitutes excessive speculation.

- 2) As you know, the House cap and trade bill gives jurisdiction over the carbon-based derivatives to the CFTC, with the Federal Energy Regulatory Commission overseeing cash transactions in the allowances themselves. Standalone legislation has been introduced in the Senate that would give the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market. Would you compare and contrast the benefits or drawbacks of giving the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market?

- A. The CFTC does not currently regulate any cash market. However, the agency has extensive experience in regulating centralized derivatives markets. The benefit of giving the CFTC oversight of cash carbon markets is that cash carbon trading would be occurring under federal oversight and conceivably be subject to regulation ensuring transparency, openness and fair and orderly markets—depending on what authorities Congress sought to provide.

The CFTC is not aware of any drawbacks to such an approach beyond the fact that such an approach would require significant additional resources.

- 3) We have heard estimates that the future carbon market under a mandatory cap-and-trade proposal will total several billions of dollars up to two trillion – according to CFTC Commissioner Bart Chilton. What is your estimate for the carbon futures market? What is your estimate for the carbon cash market? What is the size of these markets today?

The CFTC has no estimates of the expected size of the carbon futures markets under HR 2454. However, there are some estimates available for the expected size of the carbon cash market based on the cap-and-trade regime under the Waxman-Markey legislation.

These estimates are

\$60 billion in value in 2012 (Congressional Budget Office)

\$72 billion in value in 2012 (Energy Information Administration)

\$76 billion in value in 2020 (Environmental Protection Agency).

Currently futures and options contracts on the carbon emission (greenhouse gases) are traded on two futures exchanges: Chicago Climate Futures Exchange (subsidiary of the Chicago Climate Exchange) and NYMEX.

Products traded are

Regional Greenhouse Gas Initiative (RGGI) CO₂ allowance futures and options contracts;
 Carbon Financial Instrument (CFI) futures and options contracts;
 Climate Action Reserve offsets futures and options contracts;
 Certified Emission Reduction (Enropcan) futures and options contracts;
 European Union Allowance (European) futures and options contracts.

The notional value for the subject contracts for the 2009 calendar year was

| | |
|---------------------|------------------|
| Total value: | \$232,258,536.19 |
| Total NYMEX: | \$171,429,033.05 |
| Total CCFE: | \$130,633,411.50 |

Over-the-counter transactions are neither regulated nor transparent so there are no reliable statistics for carbon emissions related over-the-counter transactions.

- 4) As you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

A. The CFTC does not have a viewpoint on whether or how caps should be implemented. As the CFTC understands it, caps are intended to achieve particular policy objectives related to ensuring an overall reduction in carbon emissions and as a cost containment mechanism. Such caps could clearly have an impact on market structure as they have the potential to impact the available supply of carbon instruments, but what that impact might be is difficult to predict until more is known about how carbon markets will be structured.

- 5) How will the CFTC work with EPA to determine when or if carbon allowance reserves should be tapped? Are these reserve thresholds adequate to keep carbon costs steady?

A. The CFTC is not currently a price setting agency. It regulates to ensure fair and orderly markets, not to achieve particular price objectives. The CFTC has not conducted any economic analysis of potential carbon reserve proposals.

If the CFTC were directed to oversee a carbon reserve program the CFTC would implement the statutory directives and work with other agency partners that would also have an interest in carbon markets. The CFTC has broad authority to share data and information with other federal and state regulatory authorities and would use this authority appropriately to achieve the objectives set out in the statute.

Joseph R. Glace
Vice President and Chief Risk Officer
Exelon Corporation
Responses to Questions for the Hearing Record
November 6, 2009

Questions from Chairman Tom Harkin

1. **a.) Can you break down the costs of the over-the-counter transaction for me?**

The costs vary by transaction. In an over-the-counter (OTC) transaction, the costs are typically far less than the cost of trading on an exchange, particularly for creditworthy companies like Exelon. Exelon's credit rating enables its counterparties to extend to it some amount of unsecured credit. Exelon can also use standby letters of credit or cross-commodity netting through master netting arrangements to provide collateral or minimize a counterparty's exposure to it. Although Exelon typically does not do so, others sometimes offer liens on assets to enable hedging transactions. All of these measures can yield the same level of payment security at a much lower cost than the cost of posting margin on an exchange for a comparable exchange-traded product.

Consider the following example. Assume that in 2009 an electric power supplier wanted to enter into a fixed price power supply agreement with a utility for 300 megawatts of power in 2012 to hedge against the price volatility in the short term or spot market for power and lock in its income stream. Assume further that the market price the supplier gets from the utility is \$50 per megawatt hour. At the power supplier's current credit rating, it is typically extended an unsecured line of credit of about \$20 million. Given the power supplier's unsecured line of credit, it would not have to post any collateral at the time of the deal's execution. It would only have to post when the counterparty's exposure increases above the \$20 million threshold.

In contrast, as is demonstrated in the example below in response to the next question, doing the same transaction on an exchange through a futures contract or through a bilateral transaction that clears on an exchange, could cost the power supplier millions of dollars in up front collateral, even though at the time of the trade, the position creates no exposure for the exchange.

- b.) How much does it cost to conduct business on exchange versus off-exchange?**

The primary cost of conducting business on an exchange, as compared to off-exchange, is the substantial margin requirements mandated for clearing or trading futures contracts on exchanges. Typically an exchange will require an initial margin in the range of five to fifteen percent of the total notional value of

the transaction (the total quantity times the price). If a transaction were required to be cleared on an exchange, the exchange would determine the market value of the position on a daily basis. If the position becomes more valuable (from the exchange's perspective) because market prices have changed since the date of the transaction, the exchange will require the posting of additional "variation" cash margin. In addition to these margin costs, parties trading on an exchange also incur additional costs associated with establishing a credit facility, such as a loan or letter of credit, for the transaction and the interest costs of the required margin.

The following hypothetical attempts to provide a more specific sense of the costs of transacting business on an exchange. Like the example provided in response to question 1(a), assume that in 2009 an electric power supplier seeks to enter into a fixed price power supply agreement with a utility for 300 megawatts of power in 2012 to hedge against the price volatility in the short term or spot market for power and lock in its income stream. Transacting such a deal on an exchange would be costly because the credit line required to do business on the exchange is substantial. The power supplier would first have to meet a 5% initial margin for its hedges on the exchange. Assuming a \$50 per megawatt-hour market price, the power supplier would have to put up \$6.6 million dollars of initial margin and would have to set aside another \$66 million dollars for potential variation margin. Assuming the power supplier has a BBB credit rating, the interest expense on the \$6.6 million could be about 5% annually. The power supplier could thus incur over \$1 million in interest expense on the initial margin. The supplier might also incur about \$1.1 million more in expense to set up a credit facility for the \$72.6 million needed to meet the margin requirement for the deal. These two expenses could add over \$0.80 per megawatt hour in transaction costs. More importantly, if prices moved adversely against the position after the utility entered into the hedge, the margin requirements could increase as would the interest expense. If the adverse price move was 50% during 2009, an additional \$8 million in interest expense could be incurred through 2012, adding another \$3.10 per megawatt hour to the cost of providing the power. So the power supplier ultimately faces a potential of \$3.95 per megawatt hour, or roughly \$10 million, in interest expenses to hedge the deal, which represents about an 8% increase in power costs. In the normal course of business those costs would be passed along to the utility and its customers.

c.) What are the indirect costs associated with wider bid-ask spreads in the over-the counter markets compared to exchange trading?

The indirect costs associated with OTC transactions as compared to exchange traded transactions would be negligible. There are some legal costs associated with negotiating the agreements and addressing potential disputes that could arise. Additionally, administrative and bookkeeping needs associated with managing multiple counterparties would add some cost, but none of these costs are substantial.

d.) How much more would electricity cost your customers if you could only hedge on regulated markets with stricter margin and capital requirements?

In Exelon's view, it is very possible that a requirement that virtually all trading activity occur on organized exchanges, either through clearing or futures contracts, could increase the power prices we charge utilities and other customers we serve by anywhere from five to fifteen percent.

Questions from Senator Chuck Grassley

- 1. While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?**

First, with respect to the age of OTC markets, Exelon notes that OTC derivative transactions have been widely used for well over a quarter of a century. Their use was already so widespread by the early 1980s that the predecessor to the current international Swaps and Derivatives Association first developed its standard trading master agreement for them at that time. Currency swaps were among the first types of derivatives used to hedge risk – in that case, the risk associated with changes in the relative value of currencies. Following the abandonment of the Bretton Woods system for monetary management in the early 1970s, companies doing business internationally needed a way to hedge the risk that the value of transactions would be adversely affected if denominated in foreign currency.

Second, we believe that OTC markets will help keep the cost of compliance with carbon emissions restrictions lower than it would be without them because the cost of over-the-counter instruments will be lower than exchange traded instruments. Margin requirements will be lower, interest expense will be less, and there will be relatively more market liquidity than there otherwise would be.

2. **Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?**

An equivalent level of transparency can be achieved through the establishment of a simple mechanism for the reporting of actual over-the-counter transactions at regular intervals. Exelon and many other energy companies currently report all of their transactions of certain types to industry publications that publish indices, and in many cases, we do this daily. We have systems in place that enable us to do this. The CFTC could impose a requirement for companies to develop an on-line system to enable such reporting. The details need not be included in final legislation; the reporting requirement could be included in the statute and the CFTC could be directed to conduct a rulemaking to determine the appropriate level of reporting, the frequency of reporting, and the measures to be taken to ensure confidentiality.

In our view, this would have a substantial deterrent effect on would-be manipulators. Exelon has endorsed extending the CFTC's existing anti-manipulation authority to over-the-counter derivative transactions. An electronic reporting system would be necessary if that proposal were adopted. The CFTC would need to have access to information about transactions to enable it to fulfill an expanded regulatory oversight and enforcement function.

Questions from Senator John Thune

1. **a.) Can you provide an example of why two market participants would need to use the Over the Counter (OTC) market for a transaction in the carbon market place?**

Assuming cap and trade legislation becomes the law of the land, emitters will either be allotted, or will need to acquire, an allowance for each ton of greenhouse gas emitted from sources that are subject to the law's limitations. Emitters will be subject to a compliance obligation, which they will be able to meet either through allowances they are allotted, allowances they buy, or through reductions in actual greenhouse gas emissions. In addition to buying additional allowances, however, a market for derivatives will likely develop, which market emitters will be able to tap as a means to hedge their longer-term financial risks associated with compliance. The particulars of these hedges will be a function of the details of the cap and trade plan that is ultimately adopted.

These hedges will be developed only if an over-the-counter market for them is permitted to exist and grow. Once such a market develops and evolves, it may be that certain of its products could be traded or cleared on exchanges, just as some products used by the energy industry are now traded or cleared on exchanges. Accordingly, emitters might not absolutely *need* to use over-the-counter derivatives. They would however, benefit greatly from the reduced payment security costs associated with trading on exchanges. We have attempted to detail the additional costs that would be incurred from trading or clearing on exchanges in our answer to question 1(b) from Chairman Harkin above.

b.) In your testimony, you mentioned that forcing these unique transactions onto an exchange would dramatically drive up costs. Could you provide this committee with a better perception of why this requirement would increase costs, and how much would costs increase on account of such a requirement?

Please see our answer to questions 1(b) and 1(d) from Chairman Harkin above.

c.) With regards to these transactions, what specific types of information should be reported to ensure transparency while still maintaining the confidential information of the emitter and trader?

Please see our answer to question 2 from Senator Grassley. In addition, we note that the information that would likely need to be reported would be the basic terms of each transaction, such as the fixed price, the floating price, the quantity swapped, and the term of the transaction. There would undoubtedly be concerns about the confidentiality of the information reported because it would expose each reporting entity's market and trading strategies and other business sensitive information. The CFTC would have to provide a means to ensure that such information is kept confidential, at least for a period of time while it is still sensitive. To ensure confidentiality, rules could provide that only the CFTC and its enforcement staff would have access to the information, and perhaps that the information provided would not be subject to the Freedom of Information Act's (FOIA) disclosure requirements because it would qualify under FOIA Exemption 4¹ that excludes trade secrets and other confidential business information from disclosure. This is the case with information provided to other agencies with enforcement obligations and authority (for example, information provided to the Justice Department pursuant to a Second Request response under the Hart-Scott-Rodino antitrust statute).

¹ 5 U.S.C. § 552(b)(4) (2006).

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Dr. Dave Miller
 September 9, 2009

Chairman Tom Harkin

- 1) In your written testimony, you discussed the challenges of establishing standards for offsets. You also mentioned the costs associated with assuring the value of offset activity and that the cost could become prohibitive. Given your discussion of complicated design protocols and uncertainty about valuing offsets, would you support discounts on offsets as a mechanism to address some of the valuation and verification problems inherent in an offset program? If so, should the offsets be discounted by a standard percentage or should the discount reflect expected leakage or nonperformance?

Response: Discounts that are applied to the scientifically-determined crediting rate are an effective and efficient means of addressing uncertainties involved with quantification of agricultural and forestry offsets. The use of a discount factor can also adjust for systemic offset risk factors such as post-contract reversal risk and non-project specific leakage. Use of a discount in this manner has everyone "paying into" a risk pool that the administrator would manage to cover any unintentional reversals or to make sure the agricultural and forestry offsets are delivering at least the environmental benefits that are being credited.

We would recommend that during the initial crediting period of an offset program that a standard percentage discount be set for each type or class of offsets (i.e. soil sequestration offsets, afforestation offsets, managed forest offsets, etc.) that takes into account these estimated risks. We would recommend that during the initial crediting period that USDA undertake activities to specifically document and quantify the actual risks of contract reversals, leakage and other factors and then adjust the discount factor during the second crediting period based on these findings.

Based on the experience of AgraGate Climate Credits as an aggregator of soil offsets under the protocol of the Chicago Climate Exchange (CCX), we believe the 20% discount factor applied by the CCX is more than sufficient to account for potential post-contract reversals and quantification uncertainties.

Senator Chuck Grassley

- 1) Do you believe that it is possible for the average farmer, in Iowa or elsewhere, to recover his increased input costs, in terms of higher fuel and fertilizer prices for example, that

would be caused by a cap and trade system like in the Waxman-Markey Bill, by selling offsets?

The Waxman-Markey Bill has provisions that would make sequestration offsets from agriculture (and possibly forestry) "term credits." If that is the case, then we think it would be highly unlikely that farmers in Iowa or elsewhere would receive income from carbon offsets. In our opinion, term credits will be so highly discounted by the market since they are not fungible compliance instruments that they will have little value and few, if any farmers would accept participate in a program where what they do is not fully recognized. Waxman-Markey will result in the imposition of significant costs on farmers – higher fertilizer costs, higher fuel costs, and likely higher costs for most of their other inputs due to cost pass-through from manufacturers.

If however, the offset provisions are modified similar to those used by CCX, then we believe that most crop farmers in Iowa and in the primary corn, soybean and wheat growing areas could adopt practices that could generate carbon offsets under such protocols. However, adoption of the practice may be insufficient to generate carbon offsets if the farmer has to make commitments exceeding 5 years and assume liability for reversals that could occur after the farmer no longer controls the land. As the period of commitment required for participation in an offset program is lengthened, the ability of producers to participate in the program will be lessened. At a carbon price of \$10-\$20 per ton CO₂, we expect 10 – 30 percent of farmers in Iowa to participate in the offset program. If carbon prices increase toward \$30 per ton, participation rates could increase towards 50 percent of producers. We believe it will take carbon prices in excess of \$50 per ton to stimulate participation by more than 50 percent of producers in carbon offset programs.

Several studies have been conducted regarding the economic consequences for agriculture of a cap and trade system like the Waxman-Markey Bill, although nearly all of the analyses have assumed offset protocols for agriculture similar to those used by CCX, and not "term credits.". Analysis by Texas A&M Universityⁱ found that the representative farms in the Midwest (especially corn-soybeans farms) were more likely to see increased revenues from the sale of carbon credits from activities such as no-till farming, adoption of energy efficiency practices and other offset protocols that are likely to be developed than other parts of the country. But even in the Midwest, most of the gain reported in the analyses comes from the expectation that higher commodity prices will materialize if production is reduced due to higher input costs and shifting of productive farm land to forestry or other non-food or feed uses. We believe there is substantial uncertainty about the expectations for higher commodity prices. Unilateral land idling policies of the United States during the 1980s did not result in higher commodity prices as nearly every acre of foregone production in the U.S. was replaced by increased production in other countries such as Brazil and Argentina. Unilateral adoption of policies in the U.S. that would result in land-use shifting may have similar results where U.S. farm production declines, but world prices do not respond since the "lost" production is produced elsewhere in the world.

An analysis by the University of Tennesseeⁱⁱ indicates that revenue from carbon offsets alone will be insufficient to fully compensate for increased input costs, but if increases in crop prices are incorporated into the analysis, major feedgrain, oilseed and grain producers will see net gains, in aggregate, from a carbon cap and trade program. Livestock producers are less likely to

see carbon-related income that offsets increased production costs unless there are significant reductions in livestock production. The Tennessee analysis indicates that a cap & trade program like Waxman-Markey may result in a 13 percent reduction in beef production. Clearly the farmers and ranchers who are being forced out of the business due to economic stress will not garner enough income from a carbon program to compensate them for the increased costs. Survivors may eventually be better off, but that assumes consumers will be willing to pay significantly higher prices for meat, milk and other livestock products. Currently, there is no evidence that that is the case.

Participation in carbon offset programs by producers of peanuts, potatoes, cotton, rice, and many other vegetable crops, as well as livestock producers, will be less likely to generate sufficient carbon offset income or increased crop revenues to overcome the increased production costs that they are likely to face.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

Two primary obstacles for agriculture becoming a major source of offsets are the length of contracts that would be required and the potential for liability for reversals after the end of a carbon contract. In Iowa and Illinois, more than 60 percent of crop land is farmed on one-year renewable leases. The non-continuous nature of such leases create a significant obstacle for farm operators who lease land to participate in carbon offset programs that are likely to require multi-year contracts (some suggesting contract lengths of 5 to 10 years for soil sequestration). The second major obstacle is potential liability for reversals that might occur after a farmer no longer controls the land on which the qualifying practice was undertaken. If this liability is open-ended or deemed to be excessive, then there is likely to be less participation by farmers who rent land in the carbon offset program. EPA has expressed concern that offsets from biological sequestration may not be permanent and thus may not meet the standards that the administrator of the carbon offset program might impose. Given these obstacles, it can be understood why EPA analysis showed that the vast majority of offsets would come from afforestation as trees are planted on existing pasture lands and crop lands and that very few offsets would come from production agriculture involved in row-crop production.

Imposition of "term offset" status on credits from agriculture would be a significant obstacle to agriculture becoming a major source of offsets since the likely value of such offsets would be highly discounted in the marketplace and would create little incentive for farmers to participate. Agriculture has great potential to provide carbon credits if the policy is written in a way that is compatible with the operation of commercial farms. But that potential could go unfulfilled if the policy fails to recognize the unique attributes of agriculture and relies on unattainable absolutes.

- 3) Of the sources of ag offsets, one of the most frequently mentioned is shifting to no-till, but the EPA analysis admits that "agricultural soil sequestration does not show significant

supply.” Another option is reducing fertilizer use, but the EPA model showed what any farmer could tell you that this results in a decline in yields. Another often discussed offset possibility would be for farmers to install an anaerobic digester, but those can cost hundreds of thousands of dollars and a federal AgSTAR program report found that anaerobic digesters are feasible for only what amounts to about 1 percent of Iowa farms. How would a typical farmer in Iowa be able to receive any significant benefit from selling carbon offsets?

USDA analysis indicates that soil sequestration on agricultural land has the potential to remove and sequester between 10 to 15 percent of all U.S. carbon emissions. If the rules for carbon offsets require strict permanence, rather than recognizing that soil sequestration, while less than eternal, may have significant duration, then there will be little opportunity for farmers to realize income from offsets. However, if the rules of offsets are structured so that the full potential of soil and forestry sequestration is recognized by the program, then farmers could generate significant income from offsets. The soil offset protocol of the CCX should be a guide for development of workable protocols for agricultural soils and forestry.

- 4) In order for farmers to get paid for sequestering carbon dioxide in the soil, they would have to switch to no-till, but many farmers have already been using no-till for many years where it's possible to do so. Any farmer that was using no-till before the date we establish in law would not be eligible for payments. This could result in two neighboring farmers using no-till where the one who had switched over years ago would not see a dime and the Johnny-come-lately would receive a check for doing the exact same thing that his neighbor had been doing all along. This would surely strike most farmers as fundamentally unfair. What can be done to address the fairness issue?

A couple of points in regards to this questions. First, while a lot of farmers use no-till on soybeans, they may do minimum tillage, rather than no-till, on corn. Our experience would suggest that less than 10 percent of farmers do continuous no-till. Secondly, no-till can sequester carbon for decades. Just because a farmer is already doing no-till, unless they are under a contractual commitment to do continuous no-till for multi-year periods, they could revert to some level of tillage in order to qualify in the future for carbon offsets. We believe that in order to avoid perverse incentives, the legislation should stipulate that for agricultural practices the commencement date of the qualifying practice is the calendar year in which emission sequestration activities are first quantified and verified. Continuation of the no-till activity will prevent the release of carbon that is already sequestered and the recognition of early actions without penalizing the early actor is likely to stimulate even more participation in the emission reduction programs in the future and generate better results for the atmosphere than would otherwise be achieved by denying participation to these early actors.

- 5) We've heard a lot about opportunities for farmers to sell offsets, but it's not always clear how exactly that would work in practice. Since the farmer would actually be selling on a carbon market and offsets would need to be verified and registered, I imagine the process would be a little different from signing up for a FSA program for instance. Could you

walk me through the process a farmer would undertake to receive payment of an offset through let's say USDA, for sake of discussion?

Assuming for this question that USDA is the carbon offset program operator, a likely process for farmers to participate might be as follows:

- 1) USDA establishes a protocol (rules) that defines the activity or activities that would qualify for carbon offsets.
- 2) A farmer would sign a contract to do the practice(s) or activities that qualify.
- 3) This enrollment process would likely include a designation of the land that is being enrolled, and evidence of ownership of the carbon rights
- 4) Either the farmer (or an aggregator representing him) would make arrangements for a USDA-approved third-party verifier to verify that the producer has carried out the compliant practice or activity according to the USDA protocol. (It is possible that this verification could be a statistically-valid, random sample of a pool of participants combined with an annual certification document that the producer would file with USDA.
- 5) USDA would review the certification and verification documents and upon approval, register the offsets in the official registry.
- 6) The registry operator (which might be USDA) would issue a certificate to the producer indicating the quantity and vintage of the issued offset credits.
- 7) The farmer would then either directly market the offset certificate to a regulated emitter who needs offsets, or more likely, would contact a broker or aggregator who would put together larger pools of certificates which would be marketed to those needing offsets (likely on an electronic exchange, for market transparency).

The above description is purely speculative though since nearly all of the details regarding how carbon offsets from agricultural processes would be handled under Waxman-Markey are left up to the administrator or the Secretary to develop and define. Our comments reflect a process that would be based to a degree on the processes now employed by the Chicago Climate Exchange and other voluntary markets.

- 6) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

We believe that market transparency is critical to smooth operation of the carbon offset market and that most, if not all, registered offsets should trade on standardized contracts on regulated exchanges. We believe that OTC contracts that are based on (or reference) standardized, exchange contracts would be useful for locking in forward commitments, and to facilitate financing of dedicated, specific projects where the contract specifies actual delivery of the offset rights. We believe that there should be substantial price and quantity reporting requirements for OTC contracts similar to reporting requirements for prices and quantities in agricultural markets.

- 7) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

We support using the traditional CFTC regulatory mechanisms and requirements to assure transparency in the carbon markets as well as requiring price reporting and transparency for OTC carbon markets.

¹ AFPC Research Paper 09-2, Economic Implications of the EPA Analysis of the CAP and Trade Provisions of H.R. 2454 for U.S. Representative Farms, **August 2009**, Department of Agricultural Economics, Texas A&M University, College Station, Texas

² Some Estimated Impacts of Climate Change Legislation to the Agricultural Sector, A 25x25 sponsored webinar, Burton English, Daniel De la Torre Ugarte, Chad Hellwindkel, Tris West (ORNL), Kim Jensen, and Christopher Clark, University of Tennessee, Knoxville, TN

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Timothy Profeta
September 9, 2009

Chairman Tom Harkin

- 1) You said in your testimony that there is a fundamental trade-off between “Mitigating systemic risk and creating additional cost of posting margin.” It seems that a lot of our legislative choices come down to this type of calculation, over-the-counter transactions where businesses don’t need to put up a lot of cash to do business and exchanges where they expect you to put up some money to back your bets. But if the regulatory system does not deal effectively with systemic risk, such as that posed by OTC trading, are there not costs to that? I’m referring to the costs of using intermediaries like dealer-banks, or volatility, or economic downturns, or taxpayer-funded bailouts.

There are costs embedded in over-the-counter instruments. Cost comparisons typically compare the cash required to post margin for an exchange trade with the fact that OTC contracts may allow purchasers to pledge physical assets as collateral rather than posting cash margin or perhaps not require any collateral at all. By not requiring cash margin, OTC instruments may allow entities to use their cash flows for other purposes. OTC instruments may have transaction costs embedded in the price of the contracts, however.

Events over the past year make it clear that large markets failures can affect broad sections of the economy. Excessive risk-taking in the credit default swap markets, for example, has resulted in significant costs to society, not only through taxpayer-funded bailouts, but also through restricted credit markets and significant loss of value across securities markets. In terms of a carbon market, the cost of large scale market failures could include undermining the nation’s approach to addressing climate change. Congress can take steps to avoid these types of failures in the carbon market by ensuring that market participants properly capitalize financial risks. Reduced leverage, larger capital requirements and prudent margin requirements are all necessary parts of the solution. However, the elimination of regulatory arbitrage is also a key to a stable market, with regulators having sufficient information to evaluate the risks to which market participants are exposed.

As Congress moves forward with climate change legislation, it will have to balance the risks and costs posed by OTC instruments with the flexibility and lower cash requirements that these instruments provide for market participants.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

The evolution of the OTC market over the last ten years is highlighted by the increase in "exotic" derivatives. Plain-vanilla OTC derivatives, such as interest-rate swaps, have been around for approximately thirty years.

There are two arguments for how OTC instruments keep costs low. The first argument is that OTC contracts provide entities with the flexibility to determine the most cost effective means of hedging risk. Entities may choose OTC instruments because the instruments are not available on exchanges, such as long-dated contracts, or they need an instrument that is specifically tailored to their business needs. The second argument is that OTC contracts may allow companies to avoid tying up their cash reserves by posting margin. Exchange-traded products require initial margin and variation margin posted on a daily basis in cash (or near cash, such as government securities). A customized OTC contract can have specific parameters written into it that allows changes in the frequency for variation margin to be posted (i.e., not daily). OTC contracts may also allow companies to assign non-cash collateral as initial margin or, in some circumstances, not post collateral at all.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

There are different levels of transparency in the current commodities markets regulated by the CFTC, depending on the type of commodity and where the commodity trades. While broader market reforms currently under consideration may increase transparency in commodities markets, these efforts are still underway and it is impossible to predict what the final requirements will be. Because Congress would be creating the carbon market *de novo*, the legislation could ensure that the market regulator has jurisdiction over the entire marketplace and can track all transactions involving carbon allowances or associated derivative instruments, regardless of who is involved in the trade and where the trades occur.

Unlike traditional commodities, emission allowances issued pursuant to federal climate legislation will likely have unique serial numbers, allowing regulators to track ownership of the allowances with the proper reporting requirements. The legislation or implementing regulations could achieve transparency in the derivatives markets by requiring reporting from exchanges,

clearing organizations, trade repositories, and intermediaries such as brokers and dealers. If over-the-counter instruments are allowed in the carbon market, the rules could also require reporting directly to the regulator if the transactions are not cleared or reported to trade repositories.

Senator John Thune

- 1) Relative to other commodity markets, how large will the carbon market be? Is it possible to establish unique regulations that will result in efficiency and transparency of such a large carbon market within two years?

The Clean Energy Jobs and American Power Act would create a substantial new carbon market but would not be larger than many existing commodity markets. Economic modeling conducted by the U.S. EPA suggests that the price of emission allowances would likely be around \$13 per allowance in 2015. Just over five billion allowances would be issued that year, resulting in an allowance market worth approximately \$65 billion. As a general rule, commodities trade between 6 and 9 times their underlying value in the futures market. This suggests that the derivatives markets could exceed \$390 billion in the early years. In comparison, the value of global crude oil markets traded on the Intercontinental Exchange (ICE) and NYMEX exceeded \$17 trillion in 2008. Global futures for cotton and sugar trading on ICE reached \$154 billion and \$543 billion in 2008, respectively.

It is possible to create an efficient and transparent regulatory system to oversee trading in the carbon market. The major legislative proposals for regulating the carbon market, including the American Clean Energy and Security Act that passed the U.S. House of Representatives in June of this year and the Carbon Market Oversight Act of 2009, introduced by Senators Diane Feinstein and Olympia Snowe, are founded upon the existing CFTC regulatory model. Both bills adopt many aspects of the Commodity Exchange Act and add specific requirements to address the unique aspects of the carbon market, including some best practices from existing securities regulations. The CFTC would build upon its existing expertise rather than creating an entirely new regulatory system.

- 2) As you stated in your testimony, a cap and trade scheme will create two markets, a cash market that will trade allowances from the current year; and a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances. Should both markets be regulated by the CFTC? If so, what are the potential pitfalls of splitting the regulatory responsibility with another agency? If not, what additional resources will the CFTC need to carry out this responsibility within the next couple of years?

The CFTC is well-positioned to regulate both the spot and derivative markets for carbon allowances. The cash and derivative markets will be highly correlated and it would be most efficient to have one regulator with its eyes on the entire carbon market complex, including OTC derivatives. The recent failures in the credit default swaps markets highlight the problems caused by relying on multiple regulators to oversee various aspects of the same market.

Additional pitfalls for splitting regulatory authority include the potential for turf wars and a history of poor cooperation between various government agencies.

Generally, the CFTC will need sufficient resources to oversee the carbon market; the key to good regulation is a well-funded and vigilant regulator. I am not in a position to estimate the additional resources that will be necessary. Chairman Gensler and his staff may be able to provide you with a specific answer.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Frank Rehermann
 September 9, 2009

Chairman Tom Harkin

I am concerned that global warming's impacts – longer droughts and heat waves, increased pests, and increased disease may well be the biggest threat to farmers' abilities to make a profit.

- 1) Have you considered the potential drawbacks of inaction? How global warming will directly impact your industry?

The USA Rice Federation does not oppose responsible efforts to curb greenhouse gas emissions or climate change, including approaches such as increased use of renewable energy sources, nuclear energy, conservation, enhanced efficiencies, and other approaches that would not harm the U.S. economy or cost American jobs. We are deeply concerned that the cap and trade bill emanating from the House and similar approaches would be especially harmful to family farm operations like mine. The pending cap and trade proposal would substantially increase production costs and lower net income, threatening the economic viability of the farm. Meanwhile, I have little confidence that our trading partners will bind their farms and industry to equally rigorous emission reduction requirements, if any at all.

Senator Pat Roberts

- 1) You mention the AFPC study by Texas A&M. The representative rice farms experience lower average annual net cash income and at the same time an increase in annual costs. How does this study affect a producer's relationship with his or her lender? Credit is certainly tight already. Do you expect it to become even tighter if cap and trade legislation were to pass? How does this affect beginning farmers and ranchers?

The impact of pending cap and trade legislation ranges from even tighter margins for some to negative cash flow for others. The effect is to erode a producer's equity position, something lenders look unfavorably on when making lending decisions. For producers in the latter end of the range and especially for small and beginning farmers, the impact of cap and trade legislation could prove decisive in a lender's decision, while producers in the former range are on the bubble. This is why, in our testimony, we urge Congress to authorize the Commodity Credit Corporation to cover any increased production costs.

- 2) If H.R. 2454 were to become law, how would a rice farmer overcome the higher input costs? Would one 'good' year be enough to cover current costs plus addition direct and indirect costs associated with climate change?

We are concerned that some producers simply would not be able to overcome the higher costs and our concern is predicated on a normal or good production year as yield fluctuation from year to year is not as great as it is with respect to many other crops. Production costs and price are principle determinants on how a rice producer fares in a given crop year and the first factor is going to be greatly influenced by this legislation. Note that this is only the production side of the equation. Unlike most other commodities, rice must ordinarily be processed (i.e. milled) before it can be widely marketed in commerce, meaning there will also be increased costs borne by the producer in putting the commodity in the form necessary to market the crop. In fact, generally, rice farmers participating in cooperatives can expect to face a whole other hit in the form of lower patronage refunds, or dividends, on account of the cooperative's increased cost of doing business. And, all of this is predicated on the uncapped treatment of the agricultural sector precluding EPA-imposed performance standards or other prescriptions that the Agency could still impose under other provisions of the bill or the underlying Clean Air Act. There is no effective exemption for production agriculture and necessary processing is not even covered under the definition of agriculture sector. If cap and trade is to go forward, at minimum, there needs to be a clear exemption for agriculture production, including necessary processing.

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

Senator, as a farmer, you can appreciate that if there is a clear and responsible way to cut production costs, a farmer will do it. Few stones have been left unturned in this respect. You also know that we are price takers, so we cannot increase the price on the market. One way to offset increased costs associated with cap and trade is through the sequestration or reduction of carbon. However, as I noted in my written and verbal testimony, today that is not an economically viable and proven option for rice farmers. The only choice we are left with is to absorb the increased costs and hope to still make ends meet.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

In rice, we see no economically viable opportunity at present to avail ourselves of the offset program being discussed. We are working to develop some possibilities but we are simply not there yet. The primary objection to the forestation option is that farmers and ranchers are not foresters. Beyond that, even if we were to attempt to go that route, it would seem to me that it would involve an enormous upfront investment without the possibility for any real pay off till years down the road when the trees mature. This is a possibility for large pulp and paper companies but not to farm and ranch families.

- 3) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator, we appreciate your leadership in rejecting what was on the table in the Doha Round negotiations late last year because the agreement meant deep and, in our estimation, unsustainable cuts to U.S. domestic support in exchange for what amounts to illusory concessions from our trading partners. We have no doubt that a similar tact is being taken with respect to global climate change and the curbing of greenhouse gas emissions, as evidenced by recent media reports of comments made by Indian officials. The combination of Doha Round and climate change legislation could very well result in the kind of severe hemorrhaging of American agriculture and the jobs that go with it that we experienced in the manufacturing sector earlier this decade. So, we appreciate the tough stance that you, Chairwoman Lincoln, Ranking Member Chambliss, and others have taken in both regards.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

As noted in our response to earlier questions, we are unaware of any proven viable opportunities for rice producers to generate and market offsets in the near future.

In a world of 6.7 billion hungry people, the great majority of whom do not have the means or disposable incomes that we Americans do, we strongly reject the notion that there is greater societal or global benefit to planting trees on our rice-fields than farming them. Ours are some of the most productive acres in the world, and we would rather continue to pursue the more noble purpose of feeding the world as long as we can stay in business.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Although rice is unable to participate in the agricultural offset program, we believe that U.S. agricultural offset opportunities should not be capped. With respect to international offsets, among other things, it would seem that there would be enforcement issues that could undermine the integrity of the program, so the larger the international program the greater the uncertainty may be relative to the program's effectiveness. However, since

rice farmers are not able to effectively participate in the offset program, we have not closely examined the implications of capping international offsets. We believe the program should be structured such as to increase demand for U.S. offsets and therefore increase the value of such offsets, rather than disadvantage U.S. offsets relative to those in the international market.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System

Questions for the record

Ms. Julie Winkler

September 9, 2009

Chairman Tom Harkin

- 1) One of the more frequent complaints we hear about central counterparty clearing is that the costs associated with clearing are too expensive and that it would tie up capital that could be better invested. Could CME Clearport accept illiquid assets such as real estate or stocks and count that towards margin or capital requirements? Could you net cash and futures positions in a market where the cash and futures transactions are executed on the same platform? What other options are there to mitigate cost concerns of margin and capital requirements without compromising the integrity of the clearinghouse?

ANSWER: *Collateral that is readily convertible to cash is an essential element of the safety of a central counterparty clearing system and the only means to avoid the creation of systemic risk. The central counterparty (CCP) must hold sufficient liquid collateral to enable it to immediately meet the obligations of a clearing member—customer which defaults, since the CCP must immediately fulfill the obligations of the defaulting clearing member to each counterparty. There is no way to do this, without adding debt to the system, if the clearing house is holding illiquid assets, such as real estate, as collateral. The Green Exchange Venture currently uses CME Clearing as its CCP. CME Clearing has never experienced a default in its 110 year-plus history. CME Clearing does accept readily marketable securities, but discounts their value in a manner appropriate to recognize any likely illiquidity at the time that they must be sold to cover a loss.*

CCP's are not in the business of lending to customers. That would simply magnify the risk of operating a CCP and defeat the purpose of centralized clearing. If a customer with real estate assets needs to collateralize a cleared position, she may secure a loan from a bank and use the proceeds of the loan to purchase interest bearing securities, which may be used to collateralize her obligations to the CCP.

It is possible, in certain circumstances, to use a physical allowance to collateralize a derivative position. For example, a trader who is short an allowance futures contract may be able to collateralize his position, in whole or in part, with allowances of similar maturity.

- 2) If legislation establishing greenhouse gas emission allowances and offsets, required that all trading of the allowances, offsets and their derivatives take place on regulated exchanges, and if there is sufficient market interest for allowances 5, 10 or even 20 years in the future, would an exchange be able to offer futures contracts of longer duration? What are the practical considerations that would affect the decision to develop longer-term contracts?

ANSWER: Some futures contracts are long-dated and have adequate liquidity. For example, NYMEX's Natural Gas futures contract extends out 12 years and CME's Eurodollar futures contract extends out 10 years. However, exchange traded derivative contracts of these durations are the exception, not the rule. Price integrity is the critical component to offering long-dated futures contracts as the clearinghouse must be able to determine adequate performance bond coverage for the contracts and protect against default. Each contract month listed in a long-dated futures contract that has open interest will require a daily settlement process to employ the daily mark-to-market functions of the CCP. If legislation created a cap-and-trade program in which allowances were used for compliance over 5, 10, or 20 year periods then long-dated emissions contracts could be designed and offered by exchanges such as the Green Exchange Venture.

However, there could be challenges in generating sufficient liquidity for the long-dated instruments on an exchange. Cap-and-trade participants may be focused on shorter-term compliance obligations involving near-term compliance deadlines that can be satisfied using actual allowances and offset credits that are in their possession or in circulation. The cap-and-trade program could address this by ensuring that there are longer-term vintages of allowances distributed and in circulation. This would provide market participants with a greater certainty about the physical supply of allowances in future years. This may result in greater hedging interest and trading activity in 5, 10 or 20 year carbon futures contracts. Without such certainty of the physical supply of allowances in future years, it is unlikely that adequate liquidity will exist for long-dated exchange-traded contracts.

- 3) I see you are opposed to a transaction fee, such as we've seen in the House-passed climate change legislation. If we were to propose a user fee on these transactions to fund regulatory agencies, what would be the best way to structure it – for example, per exchange member, per transaction, per month, per year?

ANSWER: Funding for market oversight should be generated from more appropriate sources. Most cap-and-trade legislative proposals contemplate an auction for some portion of the allowances. For example, it would take less than one percent of the expected revenues from the auction proposed in the House's American Clean Energy Security Act to fund CFTC's current budget. By tying the funding of oversight resources to allowance auction revenues rather than exchange transactions, all relevant agencies (e.g., USDA, CFTC, EPA) will have resources for all of the elements that are necessary for effective emissions market oversight.

Exchange users pay trading fees which are used to fund exchange operations and the exchange's self regulatory oversight to ensure and compliance with statutory and regulatory requirements. Any additional user fee, based on transactions or targeted at only members of exchanges, will add transaction costs and make less or unregulated trading venues more attractive compared to regulated exchanges. This will impair liquidity and defeat efforts to encourage transparent, regulated trading markets.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

ANSWER: First, there seems to be a mistaken impression regarding the length of the existence of OTC contracts. Such contracts have actually been utilized for more than 20 years in energy commodities. Second, the reason such contracts came into existence is precisely because they provided innovative, lower costs ways to finance investments; indeed, in some cases, they enabled projects to get financed that otherwise could not have gotten financed at all. Furthermore, they will be the most vital in the early days of any new industry or new industry phase, which will clearly be the scenario in place upon passage of emissions control legislation. This is because the sector will essentially be "inventing" itself--that is, ramping up from a state of de minimis investment in demonstration projects to a full scale commitment to transform the entire societal energy infrastructure. No one yet knows how this will most efficiently be accomplished, so there will be no way to accurately standardize the necessary transactions.

As was stated in my written testimony, the OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies. If such OTC contracts are required to efficiently finance such projects, forcing all trading onto exchange-based platforms is likely to increase costs to utility customers.

Exchange cleared transactions require posting of liquid collateral; some entities may be able to secure more flexible terms for collateralizing their obligations in the OTC market. For example, a customer in the OTC market may be allowed to collateralize its obligations on an OTC contract by granting a lien on a physical asset. The ability to collateralize obligations to counterparties by means of liens on physical assets may

benefit power producers or agricultural offset project developers. Lower financing costs for OTC hedging transactions may translate into lower power costs to consumers.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

ANSWER: We believe that greater transparency should be required of the OTC carbon market and that all carbon-related OTC positions should be reported to the CFTC. This reporting combined with the high level of transparency available through the Green Exchange Venture will provide the additional transparency that is needed for oversight of a U.S. carbon market.

As was stated in my written testimony, CME Group will provide the market and trade surveillance services to the Green Exchange Venture. CME's highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Green Exchange Venture also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. On behalf of the Green Exchange Venture, CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Fred Yoder
 September 9, 2009

Chairman Tom Harkin

You've indicated that you think those farmers who have already engaged in practices that reduce greenhouse gas emissions should be rewarded for their early actions.

- 1) Let's take the example of a corn farmer who started to use no-till practices in 2006. How should those practices over the past few years be treated in global warming legislation? And, does it make a difference whether the farmer sold carbon sequestration credits derived from those practices on the Chicago Climate Exchange?

By rewarding early actors, we mean allowing them to participate in a carbon market moving forward, regardless of when those practices began --- perhaps through an "avoided abandonment" carbon credit. For instance, if a grower has used continuous no-till since 2006, he or she should not be disqualified from selling future offsets in a cap and trade system. Congress should avoid establishing policies that encourage growers to till up land for the sole purpose of qualifying for a carbon market. This does not mean receiving compensation for past sequestration. An individual should only be paid for the future offsets that occur as a result of these ongoing actions and not for offsets that occurred in the past. At the same time, if growers had previously participated in CCX or other trading regimes, they would be bound by the existing contract specifications until maturity.

Senator Pat Roberts

In your testimony, you mention "economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program." Since analysis shows both significant agriculture production cost increases and increased commodity prices due to a reduction in farm land acreage even with an offset program, won't consumers still feel the effects of these higher costs and prices?

To clarify the testimony, a robust offset market will significantly reduce the costs of cap and trade program to American farmers by providing additional revenue, and it would also reduce the impact of the program for the overall economy by providing a low cost mechanism for utility companies and the larger capped sector to meet their emissions targets. At the same time, our analysis indicates that all farmers and corn producers in particular, will face higher costs of production from increased energy costs. In addition to the direct energy costs is the indirect impact of higher fertilizer prices. Agriculture is unique in that farmers are "price takers" and will have very limited ability to pass these

cost increases on to consumers. Several other analyses have indicated that there is a risk of acreage diversions within an offsets program if it is not structured properly. Higher sequestration rates associated with afforestation or planting of perennial grasses could lead to higher payments for these offsets thereby diverting crop ground and pasture out of active production. These acreage shifts would reduce agricultural production, increasing prices for commodity purchasers and ultimately be passed on to consumers as higher food prices. Congress and USDA should provide a robust set of offset projects that virtually all producers could find some way to participate on working farmland. It is a mistake to focus all of our research and protocol development on tillage practices when other valuable project types could be incorporated for row crop agriculture. Policy choices and baseline assumptions in an offsets market will determine how much incentive exists for cropland and rangeland to be planted in trees. Dramatically increasing crop yield trends may also mitigate conversion except for on marginal acres.

Senator Chuck Grassley

I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

I believe if we are going to go down this road of offsets, it is essential to look at current production methods and examine ways we can reduce costs if the agriculture industry is going to continue to thrive. In looking at typical greenhouse gases such as carbon dioxide, methane (28 times more potent than CO₂), and nitrous oxide (300 times more potent than CO₂), it seems to me we need to be looking at how we can reduce nitrous oxide emissions and create an offset credit for doing this. Agronomists tell us we lose at least 30% of all nitrogen applied to soils for growing corn. When we realize that preventing just half of those losses would equate to the equivalent of the mitigation of 7 tons of CO₂ per acre, surely we can develop a science-based and verifiable protocol to establish the creation of an offset credit for virtually all corn producers across the country to participate in. The other concern about our farmers being competitive in a world economy is right on. Unless the rest of the world's agricultural producers are required to follow similar rules for producing feed, food, fuel, and fiber, we will be put in an enormously unfair position of competing. That is why the international process is so critical. We must continue to work with other agriculture groups around the world to garner their acceptance and participation in climate mitigation.

You mention that treatment of early actors, especially those who have adopted conservation tillage practices prior to 2001, should not be penalized in the carbon offset program developed. Do you have recommendations on how to address this issue, in particular for the earliest adaptors as you have highlighted?

The fact of the matter is that each and every crop grown sequesters new carbon. By penalizing the early adaptors of conservation tillage practices, it will encourage

significant reversal of those systems that have not only sequestered considerable carbon but also saved countless tons of topsoil and nutrient runoff. This is basically a policy decision which can easily be addressed by including an offset credit for "avoided abandonment" as mentioned in the Stabenow-Baucus language. This would effectively grandfather all early adopters for tillage practices without a cutoff date.

EPA numbers suggest very high cost increases to use coal. Since the Corn Belt primarily uses coal to provide our energy needs, do you believe that fuel switching will occur? To which types of fuels? What does this mean for our rural communities?

It's undeniable that the cap on existing coal-fire power plants will raise electricity rates for consumers. Research is underway to determine the feasibility of switching fuels at these plants, to include the possibility of including biomass. However, this goes beyond the simple economics of the cost of retrofitting the plant, farm level collection and processing, and transport to the plant. The use of existing crop residue (corn stover, wheat straw, etc.) has to be held to a sustainable level that does not reduce soil tillth. Likewise the introduction of new energy crops (perennial grasses, forestry) will likely compete for existing crop ground reducing crop production and increasing food prices for consumers. At the same time, it is essential for power plants to have access to a plentiful supply of low cost carbon offsets in order to continue to use coal in the electricity generation process. In fact, the energy sector has included the creation of a robust offsets market as one of their major policy objectives in climate legislation. Agriculture offsets can reduce greenhouse gas emissions while simultaneously mitigating increased energy costs for consumers.

The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

First of all, I believe the EPA analysis and the underlying FASOM model to be fundamentally flawed. EPA does not use current yield data for corn and also employs a flawed baseline for soil sequestration. Due to these incorrect assumptions, the FASOM model points to only a minimal opportunity for generating carbon credits on active farmland. It should also be noted that converting land from row crop to forestry requires its own set of investments and infrastructure, so land use decisions will not be based exclusively on the price carbon. Nonetheless, most of the research conducted to date shows that afforestation or perennial grasses sequesters more carbon than most of the proposed agricultural offsets like continuous no-till or increased fertilizer efficiency. For example if afforestation has a SR of 2 MT of CO₂ per acre and continuous no-till is 0.6 MT, a landowner would receive 3 1/3 times more payment for planting trees. At the same time, there are costs barriers to entry in the offset market for row crop agriculture. Our analysis shows that farmers experience costs for adopting a new practice like continuous no-till. There will be new equipment to purchase and in many areas there will be a temporary yield drag with no-till. These costs can be spread out over the life of the equipment and research indicates that the yield drag diminishes as farmers overcome the learning curve; however, there are still areas where continuous no-till is not a viable

production option. This is one of the reasons why enabling farmers to stack credits is so critical. It simply allows growers to gain a larger share of the offset payment while keeping land in agricultural production. These producers will still have the opportunity to adopt other offset practices, many of which have a significantly lower SR than continuous no-till. Then it becomes a question of at a lower SR is the offset payment sufficient to cover other entry costs such as verification and validation.

Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Lack of an international agreement, and more importantly a verifiable international agreement would be detrimental for U.S. agriculture. Farmers in other parts of the world could conceivably capture market share if we adopted legislation that puts our producers at a competitive disadvantage. One policy option is an "on-ramp" that delays implementation of climate legislation until other major countries have adopted similar rules.

Senator John Thune

If under a cap and trade system, ag producers are asked to sign a long-term contract, but only receive benefits of carbon sequestration for a few years or until the soil is saturated with carbon, do you think your members are likely to participate?

Both length of contracts and carbon saturation are both key issues that need to be addressed in either legislation or the final rule making process. One issue that cannot be overlooked regarding contract length is the fact that a majority of a farmer's ground is actually leased from the land-owner. Although it is not uncommon for the same farmer to farm a piece of ground for many years, it is rarely done on a multi-year contract. In addition, carbon saturation needs additional research. If the saturation time frame is set too low it is foreseeable that land used as offsets will be forced out of the program just as the largest impacts from cost of production increases are being felt. The alternative under this scenario is limited farmer participation in the early years.

In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

In the early years, no-till and conservation tillage practices will probably be the first to be considered on working farmland. However, in areas where there is continuous corn grown or where soil temperatures are cooler, widespread no-till may not be practical.

That is why it is imperative we continue to investigate methods to reduce nitrous oxide in raising corn, which could generate offset credits regardless of geography or tillage practice. Virtually every producer could participate in reducing the loss of nitrogen, which is estimated at 30%, by adopting new application technologies and using new stabilizers to keep nitrogen in place, and even reduce the amount needed to apply. Seed companies will soon introduce new biotechnology varieties that can utilize nitrogen much more efficiently and thus reduce amounts applied. Other offset practices such as using cover crops, and applying bio-char would also be attractive for farmers to use in offset projects. If policies offer a broad range of offset practice types, we will see greater acceptance from the agriculture sector and a greater willingness to participate.

Do you believe fertilizer prices will increase under a cap and trade system? If so, how high may fertilizer prices increase? Do you believe we will have a greater reliance on foreign sources of fertilizer?

Assuming the fertilizer manufacturers receive sufficient allowances to cover their increased costs, and they pass these cost savings along to growers in lower cost fertilizer there should be minimal impacts in the early years. However, beginning in 2025 and extended through the remainder of our analysis (2035) we expect significant increases in the cost of fertilizer. Our analysis shows if the price of a MT of CO₂e is \$167.16 in 2035 (EIA), corn growers would see a \$35/acre increase in fertilizer costs. Increased reliance on imported fertilizers will largely depend on two factors. First how many allowances will domestic manufacturers receive and what will they do with them. Second, how will the U.S. treat imports from countries that do not have similar climate change legislation. The U.S. is currently importing a majority of our Nitrogen fertilizer needs. In 2009, approximately 1/3 of the imports came from Canada, which would be assumed to implement similar legislation. The remaining 2/3 of imports comes largely from countries like Trinidad and Tobago, and the Middle East. As an aside, there may be opportunities for some domestic utility companies to offer new sources of fertilizer as a refined byproduct of coal scrubbing if these practices are incentivized with allowances. Recent discussions with a major electricity provider indicated their willingness to dehydrate their waste water and produce a 20% nitrogen solution that could be sold to local farmers. This could supplement our domestic fertilizer production in the future.

In the later years of the House-passed cap and trade bill, “energy intensive trade exposed” industries including the fertilizer industry, no long receive free allowances. What impact will that have on the fertilizer industry and the price of fertilizer? If most early acres of conservation tillage are saturated with carbon at this point, what impact will these two scenarios have on the cost-benefit analysis for feed grain farmers in the Midwest?

Our analysis shows that all farmers will experience cost of production increases (fuel, electricity, natural gas/propane, fertilizer). These cost increases will begin as soon as cap and trade legislation is implemented and grow over time. Our study includes the assumption that the fertilizer allowances will moderate these cost increases until they phase out beginning in 2025. The full impact of fertilizer increases will come into effect starting around 2032 and continue into the future. These factors point to the need for a robust offsets and allowance pool that is beneficial to agriculture. It’s important to

emphasize that the program must be broader than just credits for no-till. Our analysis looked primarily at continuous no-till and determined that the ability of farmers to adopt this tillage practice is not universal. Farmers in certain areas particularly northern portions of the Cornbelt, will have lower adoption rates than other growers. Protocols for other sequestration practice types should be developed by USDA to offer opportunities to all growers regardless of geography. Our analysis did not include assumptions concerning carbon saturation, but according to research from Dr. Ratan Lal of the Ohio State University, there is good reason to question some of the published data on saturation levels. His studies indicate soils can hold considerably more carbon than previously indicated. He has seen examples of continuous no-till for many consecutive years where sequestration is still taking place.

How should Congress treat the early actors of conservation practices? For example, South Dakota already had 2.8 million acres in no-till, which would not receive credit under the House-passed climate change bill since these acres were in no-till before 2001. Should these producers be able to participate in the carbon market? If so, how should these acres be treated?

The fact of the matter is that each and every crop grown sequesters new carbon. By penalizing the early adaptors of conservation tillage practices, it will encourage significant reversal of those systems that have not only sequestered considerable carbon but also saved countless tons of topsoil and nutrient runoff. This is basically a policy decision which can easily be addressed by including an offset credit for "avoided abandonment" as mentioned in the Stabenow-Baucus language. This would effectively grandfather all early adopters for conservation tillage practices without a cutoff date. At the same time, these growers would presumably still be able to participate in other offset practices in addition to no-till and stack these credits (fertilizer efficiency, irrigation efficiency, elimination of fallow, etc.).

As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

By artificially limiting participation or access to develop credits, the effectiveness and efficiencies of an open-market product will be skewed. If offsets are capped too low the price will be artificially high and will drive up energy costs for all consumers. However, under HR 2454 there is a robust domestic offsets pool with a cap of 1 billion tons as well as an international cap of 1 billion tons. There would be considerable difficulty to produce more than we would be allowed under this scenario. In fact, the industry would need access to those international credits to keep the markets competitive and to reduce the costs of the cap-and-trade program for the overall economy. The larger concern with international offsets is not capping their levels, but verification. There must be an international method to verify that the purchased offsets abroad are truly sequestering carbon. Without these assurances, offset prices will fall depriving U.S. producers of a fair market return and possibly giving our global agriculture competitors an unfair advantage.

CFTC, USDA FARM CREDIT NOMINATIONS HEARING

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION

SEPTEMBER 30, 2009

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

U.S. GOVERNMENT PRINTING OFFICE

62-716 PDF

WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

BLANCHE L. LINCOLN, Arkansas, *Chairman*

| | |
|------------------------------------|---------------------------|
| PATRICK J. LEAHY, Vermont | SAXBY CHAMBLISS, Georgia |
| TOM HARKIN, Iowa | RICHARD G. LUGAR, Indiana |
| KENT CONRAD, North Dakota | THAD COCHRAN, Mississippi |
| MAX BAUCUS, Montana | MITCH McCONNELL, Kentucky |
| DEBBIE A. STABENOW, Michigan | PAT ROBERTS, Kansas |
| E. BENJAMIN NELSON, Nebraska | MIKE JOHANNIS, Nebraska |
| SHERROD BROWN, Ohio | CHARLES E. GRASSLEY, Iowa |
| ROBERT P. CASEY, Jr., Pennsylvania | JOHN THUNE, South Dakota |
| AMY KLOBUCHAR, Minnesota | JOHN CORNYN, Texas |
| MICHAEL BENNET, Colorado | |
| KIRSTEN GILLIBRAND, New York | |

ROBERT HOLIFIELD, *Majority Staff Director*

JESSICA L. WILLIAMS, *Chief Clerk*

MARTHA SCOTT POINDEXTER, *Minority Staff Director*

VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| CFTC, USDA Farm Credit Nominations Hearing | 1 |

Wednesday, September 30, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|----|
| Lincoln, Hon. Blanche L., U.S. Senator from the State of Arkansas, Chairman, Committee on Agriculture, Nutrition, and Forestry | 4 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 7 |
| Bennet, Hon. Michael, U.S. Senator from the State of Colorado | 8 |
| Bennett, Hon. Bob, U.S. Senator from the State of Utah | 9 |
| Nelson, Hon. E. Benjamin, U.S. Senator from the State of Nebraska | 10 |

Panel I

| | |
|--|----|
| Chilton, Bartholomew, Nominee to be a Commissioner, Commodity Futures Trading Commission | 11 |
| O'Malia, Scott, Nominee to be a Commissioner, Commodity Futures Trading Commission | 14 |
| Sommers, Jill, Nominee to be a Commissioner, Commodity Futures Trading Commission | 16 |

Panel II

| | |
|---|----|
| Avalos, Edward M., Nominee to be Under Secretary of Agriculture For Marketing and Regulatory Programs and Member of the Board of Directors, Commodity Credit Corporation | 29 |
| Sherman, Harris D., Nominee to be Under Secretary of Agriculture for Natural Resources and Environment and Member of the Board of Directors, Commodity Credit Corporation | 32 |
| Spearman, Kenneth Albert, Nominee to be Member of the Farm Credit Administration Board, Farm Credit Administration | 34 |

APPENDIX

| | |
|--|----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 44 |
| Roberts, Hon. Pat Roberts | 47 |
| Avalos, Edward M. | 48 |
| Chilton, Bartholomew | 50 |
| O'Malia, Scott | 56 |
| Sherman, Harris D. | 59 |
| Sommers, Jill | 61 |
| Spearman, Kenneth Albert | 63 |
| DOCUMENT(S) SUBMITTED FOR THE RECORD: | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Edward M. Avalos | 68 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Bartholomew Chilton | 82 |

IV

| | Page |
|--|---------|
| DOCUMENTS SUBMITTED FOR THE RECORD—Continued | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Scott O'Malia | 100 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Harris D. Sherman | 137 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Jill Sommers | 178 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Kenneth Albert Spearman | 193 |
| Various organizations, letters of support and endorsement of Scott O'Malia to be a Commissioner of the Commodity Futures Trading Commission | 213-215 |
| Various organizations, letters of support and endorsement of Harris D. Sherman to be Under Secretary of Agriculture for Natural Resources and Environment and Member of the Board of Directors, Commodity Credit Corporation | 216-224 |
| QUESTION AND ANSWER: | |
| Lincoln, Hon. Blanche L.: | |
| Written questions for Bartholomew Chilton | 226 |
| Written questions for Jill Sommers | 226 |
| Additional questions for Edward Avalos | 228 |
| Barrasso, Hon. John: | |
| Written questions for Harris Sherman | 229 |
| Baucus, Hon. Max: | |
| Written questions for Harris Sherman | 231 |
| Written questions for Bartholomew Chilton | 232 |
| Written questions for Jill Sommers | 232 |
| Written questions for Scott O'Malia | 232 |
| Cantwell, Hon. Maria: | |
| Written questions for Bartholomew Chilton | 233 |
| Written questions for Scott O'Malia | 233 |
| Written questions for Jill Sommers | 233 |
| Chambliss, Hon. Saxby: | |
| Written questions for Harris Sherman | 235 |
| Written questions for Edward Avalos | 236 |
| Cochran, Hon. Thad: | |
| Written questions for Edward Avalos | 238 |
| Grassley, Hon. Charles E.: | |
| Written questions for Bartholomew Chilton | 239 |
| Written questions for Jill Sommers | 239 |
| Written questions for Scott O'Malia | 239 |
| Written questions for Edward Avalos | 239 |
| Written questions for Kenneth A. Spearman | 239 |
| Harkin, Hon. Tom: | |
| Written questions for Harris Sherman | 241 |
| Written questions for Edward Avalos | 242 |
| Written questions for Kenneth Spearman | 244 |
| Klohuchar, Hon. Amy: | |
| Written questions for Bartholomew Chilton | 245 |
| Written questions for Jill Sommers | 245 |
| Written questions for Scott O'Malia | 245 |
| Written questions for Edward Avalos | 245 |
| Roberts, Hon. Pat: | |
| Written questions for Jill Sommers | 247 |
| Written questions for Bartholomew Chilton | 247 |
| Written questions for Scott O'Malia | 247 |
| Written questions for Edward Avalos | 247 |
| Stabenow, Hon. Debbie: | |
| Written questions for Edward Avalos | 248 |
| Written questions for Harris Sherman | 248 |
| Avalos, Edward M.: | |
| Written response to questions from Hon. Blanche L. Lincoln | 249 |
| Written response to questions from Hon. Saxby Chambliss | 252 |

| | Page |
|--|------|
| Avalos, Edward M.—Continued | |
| Written response to questions from Hon. Tom Harkin | 256 |
| Written response to questions from Hon. Debbie Stabenow | 259 |
| Written response to questions from Hon. Amy Klobuchar | 260 |
| Written response to questions from Hon. Pat Roberts | 261 |
| Written response to questions from Hon. Thad Cochran | 261 |
| Written response to questions from Hon. Charles E. Grassley | 262 |
| Chilton, Bartholomew: | |
| Written response to questions from Hon. Blanche L. Lincoln | 264 |
| Written response to questions from Hon. Max Baucus | 264 |
| Written response to questions from Hon. Pat Roberts | 265 |
| Written response to questions from Hon. Charles E. Grassley | 265 |
| Written response to questions from Hon. Amy Klobuchar | 266 |
| Written response to questions from Hon. Maria Cantwell | 267 |
| O'Malia, Scott: | |
| Written response to questions from Hon. Charles E. Grassley | 272 |
| Written response to questions from Hon. Pat Roberts | 273 |
| Written response to questions from Hon. Max Baucus | 273 |
| Written response to questions from Hon. Amy Klobuchar | 274 |
| Written response to questions from Hon. Maria Cantwell | 274 |
| Sherman, Harris D.: | |
| Written response to questions from Hon. Saxby Chambliss | 278 |
| Written response to questions from Hon. Tom Harkin | 280 |
| Written response to questions from Hon. Max Baucus | 282 |
| Written response to questions from Hon. Debbie Stabenow | 283 |
| Written response to questions from Hon. John Barrasso | 286 |
| Written response to additional questions from Hon. Saxby Chambliss | 290 |
| Sommers, Jill: | |
| Written response to questions from Hon. Maria Cantwell | 293 |
| Written response to questions from Hon. Max Baucus | 297 |
| Written response to questions from Hon. Charles E. Grassley | 297 |
| Written response to questions from Hon. Pat Roberts | 299 |
| Written response to questions from Hon. Amy Klobuchar | 300 |
| Written response to questions from Hon. Blanche L. Lincoln | 300 |
| Spearman, Kenneth Albert: | |
| Written response to questions from Hon. Charles E. Grassley | 301 |
| Written response to questions from Hon. Tom Harkin | 301 |

CFTC, USDA FARM CREDIT NOMINATIONS HEARING

Wednesday, September 30, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
Washington, DC

The Committee met, pursuant to notice, at 9:50 a.m., in room 328A, Russell Senate Office Building, Hon. Blanche Lincoln, chairman of the Committee, presiding.

Present: Senators Lincoln, Harkin, Leahy, Klobuchar, Nelson, Chambliss, Lugar, Cochran and Thune.

Senator HARKIN. First I would just like to say that this is a kind of a bittersweet moment for me. I have been honored to chair this Committee and I have been honored to be on it for 25 years now and then 10 in the House. It has just been a great pleasure and honor to be able to be the chair of this wonderful Committee and I want to thank all of the members of the Committee for the great cooperation that you have given me in the past and for especially in the development of the last Farm Bill.

I especially want to thank Saxby Chambliss for a great working relationship, both personally and among our staff, and I cannot thank you enough for all that we did together to work together to get a really great Farm Bill through and I want to thank you for that.

However, I must say that my sadness in leaving the chairmanship is more than compensated by the knowledge that the person taking over the chair is someone that is devoted, devoted to the well-being of our family farmers, is devoted to the economic vitality of our rural communities and, of course, to the nutrition of our children.

And so I am honored to be able to turn over the gavel this morning to Senator Lincoln. I am cognizant of the fact that this is indeed an historic moment. No woman has ever chaired this Committee and this will also be the first Arkansan to ever chair the Agriculture Committee.

So it is with great pleasure and great pride to be able to give the gavel now to you, Senator Lincoln of Arkansas, and we are proud to call you our chairman.

[Applause.]

Chairman LINCOLN. Thank you. Thank you all so much for such an incredible warm welcome to this chairmanship. I am enormously grateful to all of my colleagues for their confidence that they placed in me in the ability to run this Committee and I am

so indebted to each and every one of them for the unbelievable devotion that they give to this Committee.

I know with that kind of devotion, hard work and friendship, we are going to do great things in the Senate Agriculture Committee. So thank you so much, Chairman Harkin, and to all the former chairmen who are here, which are a lot. So I am very grateful and thanks to all of you all for participating in my first hearing, which I am delighted to be a part of.

Senator CHAMBLISS. Madam Chairman, before you take off on your first official business, let me say first of all to my good friend Tom Harkin, I appreciate those kind comments. It has been a real pleasure to work with you, Tom. We have had a great working relationship and as you say, our staffs have worked extremely well together and we have been through some difficult times together trying to look after American farmers and ranchers.

Under your leadership, I think we have accomplished an awful lot. We will still call you Mr. Chairman, but it will just be in a little different capacity there. But we look forward to having you continue on this Committee and you are exactly right that handing off the gavel to Blanche Lincoln has to be a pleasure for you and certainly a pleasure for me.

Blanche and I worked on so many issues together, both on the Ag Committee and off the Ag Committee. When I sit down with her, I do not need an interpreter. We seem to both speak slowly enough that we can understand each other, coming from the same part of the world. She, obviously having grown up on a family farm, knows and understands and has a great appreciation for the difficulties that farmers and ranchers are going through right now.

Her leadership is going to pick up right where you left off, Tom, and we are not going to miss a beat. She is such a great friend, a great leader. It is going to be a lot of fun to have a chance to work with you Blanche, so congratulations to you. Your colleagues on the Democratic side have made a wise choice in bringing you forward.

Gosh, we are going to have to get a wide angle lens, sure enough, to get all of these former chairmen that are in this room now and on this Committee in any photograph. I think that speaks well for the Committee.

Chairman LINCOLN. It does.

Senator CHAMBLISS. We look forward to your leadership.

Chairman LINCOLN. Thank you.

Senator CHAMBLISS. Congratulations.

Senator LEAHY. Madam Chairman.

Chairman LINCOLN. Absolutely.

Senator LEAHY. If I could just make—as one who has served on this Committee now for 35 years, I am delighted to see you here. You are a true daughter of rural America and for those of us who were born and raised in rural America, it means a lot. It is more than just particular commodities, but it is what it means for all of rural America and the need for us to have you here.

I do want to commend both Tom Harkin and Saxby Chambliss for the way they have switched hats back and forth and the way they have run this Committee in a bipartisan, often non-partisan fashion, and that means a lot. Dick Lugar and I did that. As both

chairman and ranking member, we had the opportunity, both of us, to serve in both capacities and be able to work out most things. I think it is because we were able—I wish we could do that in all committees. Not thinking of any one in particular, but the fact that we were able to work things out and you have that ability.

Thad Cochran, the same way, has chaired this Committee. Maybe we should have a special chairman pin or former chairman pin, because we are all here.

Chairman LINCOLN. We will work on that.

Senator LEAHY. I will tell one very quick story, which Senator Lugar knows. When we were both brand new members and sitting way, way down at the end, and former chairman, Herman Talmadge, and Jim Eastland were sitting up here and Senator Eastland brought up some little old amendment, it was about this thick, and just hands it to Talmadge and says, Talmadge says, well without objections, it is accepted.

And I said, wait a minute, could I ask what is in that? The two of them pulled their cigars out of their mouth, looked way down where Lugar and I are sitting. Dick and I are there. They were trying to figure out whether it was Dick Lugar said it or I said it. Either way, they did not know who the heck either one of us were. Talmadge just says, we are adjourned.

[Laughter.]

Senator LEAHY. You will be a different type of chair.

Chairman LINCOLN. I promise.

Senator LEAHY. Thank you and I will go down to Judiciary.

Chairman LINCOLN. Well, thank you, Senator Leahy.

Senator LUGAR. Madam Chairman, if I am just a moment spurred on by Senator Leahy's comments about the two of us sitting at the end of the table, the table then extended almost all the way to the door. As I recall, those who are now sitting in the chairs in the way were on the sidelines in some fashion.

There was mention of smoke. As a matter of fact, the chairman and Senator Eastland were engulfed in smoke so that we could hardly see their faces in the midst, a change in culture during the period of this thing.

Chairman LINCOLN. We are growing and changing.

Senator LUGAR. Yes. We appreciate your coming to the chairmanship very much.

Chairman LINCOLN. Thank you.

Senator LUGAR. We look forward to working with you.

Chairman LINCOLN. Absolutely. We do.

Senator KLOBUCHAR. Madam Chair?

Chairman LINCOLN. Yes?

Senator KLOBUCHAR. If I could just on behalf of the women in the Senate, we are so excited about you taking this new position. I was thinking of all those girls in 4-H showing up at our state fair and all those farming women out there. You have really set a new standard and a new mentor for people who farm and women who farm.

So I wanted to just say that, and I will miss making Iowa jokes to the chairman. I can't. You know, Minnesota, we like to do that.

Chairman LINCOLN. But Arkansas is so much more colorful.

[Laughter.]

Senator KLOBUCHAR. Yeah, I am sure there are no Arkansas jokes that I can come up with. I do know Minnesota, Arkansas are No. 1 and three for turkeys in the country.

Chairman LINCOLN. There you go.

Senator KLOBUCHAR. No one should make turkey jokes. But congratulations again and thank you for your chairmanship, Senator Harkin.

**STATEMENT OF HON. BLANCHE L. LINCOLN, U.S. SENATOR
FROM THE STATE OF ARKANSAS, CHAIRMAN, COMMITTEE
ON AGRICULTURE, NUTRITION, AND FORESTRY**

Chairman LINCOLN. Well thank you all and I am going to call the Committee to order here. The Committee on Agriculture, Nutrition and Forestry will come to order.

Just a special thanks to all of you all and would hope you would allow me to begin on a personal note since this is my first opportunity to officially chair the Committee. It is a tremendous honor to serve as chairman of this Committee and I will endeavor to be the type of steward of this position that the American people and the people of Arkansas deserve. With all of your help, I know I can accomplish that.

As all of you know, the Senate Agriculture Committee does have a well earned and a time-honored reputation for bipartisanship and for working together to promote policies that are born not out of partisanship, but out of consensus as to what policies are proven to work. I could not ask for a better partner than my ranking member here, Saxby Chambliss.

I have the privilege and benefit of serving beside five previous chairmen of this Committee and one previous chairman of the House Agriculture Committee—I will not forget my good buddy Pat Roberts who I had to beg to get on the House Ag Committee and he finally let me on—each of whom have served with great distinction and from whom we have learned a tremendous amount.

Also among our Committee's membership, I count four chairmen, three ranking members of our very important Senate committees, as well as a former secretary of Agriculture and the Senate Republican leader, each of whom adds to the collective experience, strength and wisdom of this great panel.

So let me always say that I truly appreciate the regional diversity that is reflected on this Committee and the unique areas of expertise and interest possessed by each of our members on the Ag Committee. Despite significant policy challenges that we have faced over the years, and even differences of opinion now and again, this Committee has always pulled together and risen to the occasion.

In short, I am very, very proud of each member's contribution to this Committee and I appreciate what each of you all will bring to the table as we move forward on so many critical issues. I am really looking forward to working with each of you all. We have a lot of things on our plate and promoting economic opportunity and jobs in rural America in these economic times, we have great opportunity.

My dad always said, when you have tremendous challenges, look hard because you will find the opportunities. We have opportunities in meeting the nutritious needs of our school children and el-

derly and low-income families, again, particularly in these economic times and continuing to build our successful resource conservation efforts, which we know and many of us have experienced and realized whether it is on our farms or without a doubt in working with your farmers and ranchers across the country.

We have the opportunity of enhancing America's energy independence and ensuring that the men and women who have clothed and fed this nation in a manner that is unrivaled in history continue to do what they do best, and that we can reinforce them and we can empower them to continue to do that and I look forward to it.

In this last regard, I would like to quote our late President John F. Kennedy who said, our farmers deserve praise, not condemnation and their efficiency should be cause for gratitude, not something for which they are penalized. With 6.8 billion people sharing this world that we live in today, compared to the roughly three million in 1960, President Kennedy's words ring truer today than ever before.

I know and you all know that sometimes the Ag Committee is not the most glamorous committee on Capitol Hill, but we have a tremendous responsibility and opportunity to really reflect to the American people and the world the hard working men and women, their families, across this great country that do such a tremendous job.

So whether you are from Iowa or Arkansas, Georgia or Vermont, California or Idaho, if you work to feed and clothe this nation and those around the world, all across the globe, this chairman and this Committee are firmly on your side. And I know that the ranking member of the Committee, my good friend, Saxby Chambliss, shares these goals and sentiments and I could not have a greater friend or a more respected Senate colleague than my partner on this Committee and I am grateful to you, Senator Chambliss, for everything you and your staff do. I look forward to so much moving forward and getting started on the business of the Committee.

We are going to have a good time. We will work hard. We will play hard and we will get things accomplished and I am grateful to you for your friendship and help.

So now, moving on to the purpose of this hearing. We have all had a great stroll down memory lane and we are going to allow the chairman to move to his new chairmanship.

Senator HARKIN. Madam Chairman, this also is my first day to chair my new committee, so I beg your leave. I have to leave to go chair my committee.

Chairman LINCOLN. Well good luck to you and thank you again, Mr. Chairman.

Senator HARKIN. Congratulations.

Chairman LINCOLN. Absolutely. So now we will move on to the purpose, as we say our good byes here, to the hearing at hand.

Today the Committee is meeting to consider six nominations to the USDA, the CFTC, the Farm Credit Administration, and specifically, we consider two nominees for the U.S. Department of Agriculture, Mr. Harris Sherman and Mr. Edward Avalos. Sorry, got to get that one right.

Mr. Sherman has served as executive director of the Colorado Department of Natural Resources for Gov. Bill Ritter and Richard Lamm. In this capacity, Mr. Sherman gained experience working on policies that he would be responsible for if confirmed as the under secretary for Natural Resources and Environment, including management of the Forest Service and the Natural Resources Conservation Service.

Mr. Avalos—help me with that—Avalos has been nominated to serve as the under secretary of Marketing and Regulatory Programs. If confirmed, his mission would touch upon virtually all of American agriculture. The three agencies under his jurisdiction, the Animal and Plant Health Inspection Service, the Grain Inspection Packers and Stockyards Administration, and the Agricultural Marketing Service have broad ranging and important responsibilities within the department.

Mr. Avalos was raised on a family farm in New Mexico, where a variety of specialty crops are grown, including chili peppers, pecans, onions, as well as staple crops like cotton and wheat. His career in agriculture includes 29 years of service at the New Mexico Department of Agriculture, where he successfully worked to implement trade and promotion initiatives aimed at increasing U.S. farm exports. Mr. Sherman and Mr. Avalos are also nominated to serve as members of the board of directors of the Commodity Credit Corporation.

We also meet to consider three nominees to the Commodity Futures Trading Commission, Bart Chilton, Jill Sommers and Scott O'Malia. The CFTC is tasked with regulating commodities futures and options markets dealing with everything from cotton futures to financial derivatives.

CFTC polices the markets that affect everything from the food we eat to the gas that we put in our car to the loans we borrow at our local banks. The CFTC protects market participation from fraud, manipulation and other abuses while making certain that the markets are fully functioning.

Congress, and in particular, this Committee, will soon consider financial regulatory reform and the CFTC will have a front and center role in this effort. In light of this, I am pleased that the Committee is moving as expeditiously as possible to consider these three nominees who bring years of experience, knowledge and diverse perspectives to the Commission.

The Commission and the staff at the CFTC face significant challenges and a heavy workload in the coming months, so it is vital to have this highly qualified team on the job.

Finally, we consider the nomination of Kenneth Spearman for the Farm Credit Administration Board. The Farm Credit Administration is responsible for regulating and examining the banks, the associations and related entities of the Farm Credit System and Farmer Mac. In 2007, Farm Credit System held about 34 percent of the farm sector's total debt, as much—such who serve on that board play an extremely important role in ensuring the continued availability of stable and adequate credit in farm country all across the nation.

Mr. Spearman brings a wealth of experience to the Farm Credit Administration Board. His work in cooperative banking and on fi-

nancial policy issues over the last 28 years will be an invaluable asset to the Farm Credit Administration. Mr. Spearman is nominated for a term that expires next year and for a full 6-year term that expires in May of 2016.

I look forward to the statements of the nominees and their answers to the questions that members of this Committee may have. I would now like to yield to the ranking member, Senator Chambliss, for any statement that he may have and then we will have introductions from other senators.

STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM THE STATE OF GEORGIA

Senator CHAMBLISS. Well thank you very much, Madam Chairman, and boy, it has a great ring to it, Madam Chairman. Again, I want to congratulate you on taking the gavel, just to let you know that you have great friends on this side of the table, and as Senator Leahy said, we have always had a bipartisan committee that is going to get even stronger as we go through the final implementation of the current Farm Bill and look forward to working on the next one as we are already approaching that.

I think we would be a little remiss if on this side we did not recognize the great work that the staff of Senator Harkin has done. And to Mark and Susan, thank you all for your great work, your great cooperation and your commitment to agriculture across the country, and Madam Chairman, to you for bringing Robert Holifield back to the Committee. We are very pleased to have him back, having worked very closely with Robert on the Farm Bill last year. He brings a great wealth of knowledge not just there, but I just saw Chairman Gensler a minute ago, who has come to show his generous support for these nominees.

I know he hates to lose Robert at CFTC, but if we move forward to financial reform, this Committee is going to play an integral role there and Robert has a very strong background that he can bring to the table now to help us. So Robert, we are pleased to have you here as a staff director under Chairman Lincoln. It has a great ring.

Madam Chairman, thank you for holding this important hearing and to consider these nominations pending before the Ag Committee. As we seek to reform our financial system, address the ongoing credit crisis, and have the recently enacted Farm Bill properly implemented, it is vital that we have good leadership in place at the Commodities Futures Trading Commission, the Department of Agriculture, and the Farm Credit Administration.

Commissioners Jill Sommers and Bart Chilton are no strangers to the Ag Committee. Both were previously nominated by President George W. Bush and confirmed by the Senate. President Obama recognized their commitment to ensuring that our commodity markets function properly and the need to keep them in the trenches during this critical time.

I would also like to welcome Scott O'Malia to the Committee. It has been far too long since the Commission was fully seated and Senate confirmed. We must seek to have all three of these nominees confirmed in a timely manner so that all five commissioners can get to work on the important task that the American public ex-

pects them to tackle. The chairman and I were visiting earlier. I am not sure when was the last time we had five full-fledged Senate confirmed commissioners, so this will be an important historical monumental achievement here.

Speaking of tasks, the Food Conservation Energy Act of 2008 was an enormous undertaking by Congress and was enacted over a year ago. It expires in 2012 and yet there are a number of provisions yet to be implemented. The Marketing and Regulatory Programs' mission area at USDA covers many of these provisions. Mr. Avalos, as under secretary, you will oversee a very diverse portfolio at USDA, including plant and animal health, marketing programs and commodity procurement, enforcement of grain standards and fair practices in our meat and livestock industry.

While each of these missions is distinct, they are important to protecting our producers and expanding markets for their products. I trust your long experience with both the Texas and New Mexico Departments of Agriculture will make you a true asset in this role.

Mr. Sherman, you will have a very big job managing our national forests and grasslands, but you will also oversee USDA's programs and activities that promote private land stewardship and conservation. These are the programs that help producers help the land. I look forward to working with you to see that the Farm Bill conservation programs are implemented as Congress intended and are working for producers.

Though there is a pain in agriculture, it generally has not suffered as much as other parts of our economy over the past year. I believe this was due in large part to the sound financial management adopted by producers and their lenders, including the Farm Credit System, over the past 20 years. I hope and expect that will continue into the future and Mr. Spearman, in your role, when confirmed as a member of the board of the Farm Credit Administration, it will be your job to help see that this happens. With your experience in agriculture, accounting and finance, President Obama has found an excellent candidate for the board of the Farm Credit Administration. I am pleased that you have agreed to serve in that position.

Again, I want to thank Chairman Lincoln for making these nominations her first priority and I look forward to a speedy hearing and confirmation of all of these nominees. Thank you.

Chairman LINCOLN. Thank you, Senator Chambliss. We have some guests that are here to introduce some of our nominees and Senator Bennet, I would like to turn to you first since you are here to introduce Mr. Sherman. We are going to do all the introductions first and then we will bring everybody up, because I know that the other senators have other places to go.

Senator BENNETT. Is it you?

**STATEMENT OF HON. MICHAEL BENNET, U.S. SENATOR FROM
THE STATE OF COLORADO**

Senator BENNET. It is me, unless you know Harris Sherman too, in which case, it is better with one T.

Well Madam Chair, let me just say first, congratulations on assuming the chairmanship. I had the good sense, as you know, my

colleagues, you may not know, to marry a woman from Eastern Arkansas, from—

Chairman LINCOLN. That is true.

Senator BENNET [continuing]. The next town over from you. She sounds a lot like you, but she is not the chairman of the Agriculture Committee. But I will say—

Chairman LINCOLN. She is chairman at home though, isn't she?

Senator BENNET. She is. She is, particularly because we have three daughters. But I know how proud everybody back home must feel about that. I know how proud Susan and her folks are of this and so from them, let me say congratulations.

Chairman LINCOLN. Thank you.

Senator BENNET. It is my pleasure today to introduce Harris Sherman and speak in support of his nomination to be under secretary of Natural Resources and Environment at the department. I would also like to welcome his daughter Jessa, who is here today, his sister Barbara Kailey, his brother David Sherman and his niece Shawn Kailey Reagan, who are all here today.

I have known Sherman since 2003, when he was serving as a commissioner on the Denver Water Board. Today Harris serves as executive director of the Colorado Department of Natural Resources and is a member of Governor Ritter's cabinet. As director, he oversees Colorado's energy, water, wildlife, parks and state lands programs. Through the years, I can tell you that Harris has demonstrated an ability to solve difficult problems and balance competing interests regardless of the politics.

If confirmed, his experience making hard decisions as chairman of the Colorado Water Quality Control Commission, chair of the Colorado Mined Land Reclamation Board and chair of the Denver Regional Air Quality Council—There is not much left in Colorado by the way—as well as his work with several non-profit land organizations will prove important as the Nation faces some of the most challenging natural resource issues in decades.

I also want to note that Harris will be charged with overseeing the U.S. Forest Service and the Natural Resources Conservation Service. We know that forest and agriculture are particularly vulnerable to the hazards of climate change and we have seen it in Colorado. In Harris, I know Congress will have a willing partner as we move forward with a pragmatic agenda for protecting our forests and agricultural sector from this severe threat.

Harris has been an invaluable asset to Colorado and made contributions to our state we will never forget. We are glad to share his talents with the rest of the country and I proudly introduce him to the Committee. Thank you, Madam Chair.

Chairman LINCOLN. Thank you, Senator Bennet.

Senator BENNET. Congratulations, Harris.

Chairman LINCOLN. Now the other Senator Bennett, from Utah, as a guest here. I think you wanted to introduce Mr. O'Malia.

STATEMENT OF HON. BOB BENNETT, U.S. SENATOR FROM THE STATE OF UTAH

Senator BENNETT. Thank you very much, Madam Chairman, and we go from one T to two. Whether that is progress or not, I do not—unlike those who talk about a long experience with the person

they are introducing, my relationship with Scott has been relatively brief. We became acquainted just a year ago.

He was nominated for this position in the previous administration and his nomination was blocked by a senator who had a problem not with him, but another problem, and used his nomination as the way to express distress over what the administration was doing. As a consequence of that, when I took over Senator Domenici's slot as the ranking member on the Energy and Water Subcommittee of Appropriations, I inherited Scott.

I am thinking of putting a hold on this nomination myself in an effort to hang on to him because I have found that this young man has an intellectual capacity to grasp a problem, understand it, and then just as importantly, explain it to someone who is a little less qualified to understand the particulars, like myself. He has been an absolutely invaluable member of the staff at the Energy and Water Subcommittee, understanding all of these issues tremendously, high level of energy and activity. There is nothing you can ask him to do that he does not dig into very, very vigorously and very, very well.

I think he will do a superb job at the Commodity Futures Trading Commission. But I will reluctantly give him up to recognize that there comes a time in everybody's career when they need to move forward. I can recommend him absolutely without any reservation as a dedicated public servant with intelligence, integrity and energy that will do a superb job wherever it is he goes.

So I am honored that he has asked me to make this recommendation and I assure the Committee that voting for Scott, and will assure the Senate, that voting for Scott for this assignment is something that we will look back on with great pride and sense of satisfaction as he proves his capacity in whatever assignment he might ultimately get. He has my unqualified endorsement.

Chairman LINCOLN. Thank you Senator Bennett. Senator Cochran, did you—

Senator COCHRAN. Madam Chairman, thank you very much. I have a statement supporting the nomination of Scott O'Malia, which I would ask to be printed in the record. I enthusiastically, as Senator Bennett did, endorse his nomination and urge the Senate to confirm him at the earliest possible time.

Chairman LINCOLN. Great. Thank you. Without objection, we will enter that in the record.

[The prepared statement of Hon. Thad Cochran can be found on page 44 in the appendix.]

Chairman LINCOLN. Senator Nelson is going to join you all over on this side. It is OK. Wherever. We are one big happy family over here.

**STATEMENT OF HON. E. BENJAMIN NELSON, U.S. SENATOR
FROM THE STATE OF NEBRASKA**

Senator NELSON. Thank you, Madam Chair, and I want to introduce Ken Spearman. Where is he? I just walked in. There he is.

Chairman LINCOLN. He is in the back.

Senator NELSON. He is the president's nominee to the Farm Credit Administration Board and his wife, Maria is here. Where is

Maria? Over here. They live in Winter Haven, Florida and that is right in the heart of Florida's citrus belt.

The Farm Credit Administration is obviously vital to your agriculture in this country and it is the largest source of credit to farmers and its effective functioning is crucial to our economic health. You all know this. Given his unique background and experience, he is especially suited for this position. He has been a 28-year veteran of the citrus industry and he serves as a director on the AgFirst Farm Credit Bank, so he is very well versed in banking and finance policy issues.

I think we ought to point out that he is a veteran. He is a Vietnam veteran. He served in Vietnam. Clearly Ken has been involved in a lot of civic and social programs, including tutoring in an adult literacy program, and has been chairman of the board of the Lake Wales Medical Center. I just want to bring all of this to the attention—obviously this is going to be unanimous by acclamation, but I wanted to say my two bits for him, and Madam Chairman, I am going back to the committee meeting that you are missing right now.

[Laughter.]

Chairman LINCOLN. I'm hearing regularly from them. Thank you, Senator Nelson. We appreciate it. Appreciate all the members here in support of our nominees.

To begin this, now we address at hand the business of the day, and if I may, I would like to ask all of you all if you would stand to take an oath.

Raise your right hand. Do you swear to tell the truth, the whole truth and nothing but the truth?

Mr. CHILTON. I do.

Mr. O'MALIA. I do.

Ms. SOMMERS. I do.

Chairman LINCOLN. Great. Again, a mandatory question for you all, do you agree that if confirmed, you will appear before any duly constituted committee of the Congress if asked?

Mr. CHILTON. I will.

Mr. O'MALIA. I will.

Ms. SOMMERS. I will.

Chairman LINCOLN. Great. Thank you. And I would just say to all of our nominees, if you do have family in the room and you would like to introduce them, please do so. Our families are a big part of all of our lives and it is important.

Mine are off in many different places, but I know my sweet dad is looking down on me right now. He was a rice farmer in Arkansas and a salt of the earth man and he is looking down on me today as I take over the Senate Ag Committee, so I hope you all will take that opportunity.

Commissioner Chilton, we would like to hear your statement and we will go through and have questions after that.

STATEMENT OF BARTHOLOMEW CHILTON, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. CHILTON. It is a pleasure to be the first person to say thank you, Madam Chair, and thank you to the members of the Com-

mittee, particularly the former chairs, who have spent so much time on the futures industry, more than you may have wanted, but we appreciate it.

The industry has changed dramatically over time. Agriculture, while it remains critically important not just to me, but to all the members of the Committee, is really only 7 percent of the futures industry right now, as I say, an important part. Euro dollars are the No. 1 traded contract. On the physical side, crude oil is the No. 1 physically traded contract.

The markets are now—even last year I was here, it was 80 percent traded electronically. Now it is 90 percent, so the pits are sort of on their way out. The futures industry just in this decade has increased fivefold and \$200 billion has come in from what I term as new speculators, and these are different market participants. These are university endowments, hedge funds, pension funds from state and local government, electronically traded funds, index funds, et cetera.

They have a different modus operandi from the traditional commercial participants who have been in these markets, like farmers and ranchers and processors. They are different in really two primary ways. First of all, they do not have an interest in the underlying physical commodity, whether or not it is wheat, corn, cotton, soybeans, or crude oil, et cetera.

Second, their trading strategy is different in that they are not concerned about the daily ups and downs or supply and demand. We term them sometimes price insensitive and I am talking generically about them. Everybody has a little bit different strategy. But what that means is they are concerned with a longer time horizon in trading. They are concerned with, for example, if crude oil will be worth more in 5 years than say it is today, but not so much in the daily stuff.

And so there is a question about whether or not these new speculators have had an impact that may have been unintended on markets, creating an artificial price. Rice University recently said that they were. The Petersen Institute earlier this week, or maybe last week, said that they were. But in fairness, there are lots of studies that say that they are not having an impact.

So as a regulator, what do you do? My view is they are having some impact. Two hundred billion dollars, I think, has an effect. Now I am not suggesting they are driving prices or I think the fundamentals of supply and demand are well intact, but they are having an impact.

But even if you just suggest that it is possible that these new speculators here are having an impact, it is uneconomic, and by that I mean divorced from supply and demand. Even if they are artificially having an impact on prices or have the possibility of it, the Commodity Exchange Act says that we are to deter that. So what appropriate mechanisms do we use that you all have given us through the act to try and ensure that there is no fraud, abuse or manipulation? One of the things we are looking at is putting a limit on positions for traders.

This has worked pretty well with some hiccups, significant hiccups in the last couple of years actually, but it has worked fairly well in the Ag complex. But we do not have it in the energy com-

plex. We do not have position limits in the back months and we do not have them in the metals complex either.

So I think some reasonable level may be appropriate. We have never been about saying to a trader, you are not tall enough to ride, you cannot participate in these markets. But it seems to me that if it is impacting the risk that commercial producers are using, that we certainly need to consider it. But we need to look at all of the markets, not just the regulated markets, and that means the over-the-counter markets, which are currently unregulated.

In that regard, there are three things that I would like you all to consider on this Committee and in Congress that I hope will be included as part of what you do on regulatory reform. First of all, I would like to ensure that we get this OTC authority to look at the OTC markets and to regulate it when it is going to impact price, the price that people pay for gas and putting it in their cars or food on their table.

Second, our manipulation authority needs to be, though standard, needs to be lowered. People have a hard time believing this. In the 35 years that the CFTC has almost been around, we have only had one, one successful manipulation prosecution and that one is under appeal. So clearly the standard needs to be lowered.

And the third thing is criminal authority. I would like to get more of these financial felons and financial fraudsters put in jail. If they do the financial crime, they should do the time, something similar to what Beretta used to say. Now they just pay the civil monetary fine. It does not quite have the same zip to it, does it? And it does not have a deterrent effect either.

And the final thing, and this is something I think we can do back at the ranch at the CFTC, not for you all, but I want you to know that we are on the case, and that is dealing with consumers. All of these market participants, there is a lot of new retail participants, a lot of individuals who are trading and they are in their basements and offices, et cetera, and we do not have anybody right now at the CFTC whose mission, mandate and mantra is consumer literacy, helping them understand what is going on and how these markets work.

If you look at what has been going on with all the Ponzi cases, there is rampant Ponzimonian going on, not just in the U.S., but around the world, and we need to do a better job. A lot of folks that have good hearts and limited incomes are being taken advantage from fraudsters and I am hopeful that with the people dedicated to consumer education and consumer affairs at the CFTC that we will do a lot better job in the future.

Thanks. Congratulations again, and I look forward to taking any questions at the appropriate point.

[The prepared statement of Mr. Chilton can be found on page 50 in the appendix.]

Chairman LINCOLN. Thank you, Commissioner. I also would like to—as we are looking to fill the seats here at the CFTC and bring good help over there, Chairman Genzler, where is—there he is right there. He is hiding. I did not see him at first.

Chairman please stand up and let us thank you for the job that you do.

Mr. CHILTON. Commissioner Dunn is also here with us.

[Applause.]

Chairman LINCOLN. And Mike? I saw Mike when he was coming in and waved at him. Mike Dunn as well as commissioner. So thank both of you gentlemen. We appreciate your being here.

[Applause.]

Chairman LINCOLN. Mr. O'Malia.

STATEMENT OF SCOTT O' MALIA, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. O'MALIA. Madam Chairman, Ranking Member Chambliss and members of the Committee, thank you for the opportunity to testify today. Madam Chairman, I would like to congratulate you on your accepting the chairmanship of this Committee. As a father of three daughters, we are always looking for positive role models, and today is a very good teaching lesson.

I am grateful to appear before you as President Obama's nominee to serve as commissioner of the Commodity Futures Trading Commission. I would like to thank Senator Bennett for his support and willingness to introduce me to the Committee. As a Michigan native, I would also like to thank Senator Stabenow for her support as well.

Before I begin, I would take you up on your offer to introduce my family. I am joined by my wife, Marissa, three daughters, Kelsey, Claire and Macey, and I am joined by my parents, John and Bev O'Malia. I appreciate their—

Chairman LINCOLN. Why doesn't everybody stand up so we can greet you as well?

[Applause.]

Mr. O'MALIA. I am honored to be nominated by the president to serve on the CFTC. Given the fact that this country has experienced the worst financial meltdown since the Great Depression, I recognize the enormous responsibility of this office. Like everyone in this nation, I too have lost value in my home, retirement and college savings. I am sensitized to the hardship this crisis has caused families across the country.

This experience reinforces my strong belief that our nation's financial regulators must be vigilant in their oversight responsibilities to ensure transparency and accountability in our markets. Furthermore, regulators must recognize the inherent risk associated with trading products which have contributed to the crisis and they must commit to doing all they can to maintain stability and security of these markets.

I believe the oversight of our financial institutions must be strengthened. I am committed to exposing the underlying risks and trading practices that might further destabilize our economy. For the past 6 years, I have worked in the Senate serving in the Senate Energy and Natural Resources Committee and the Senate Appropriations Committee. During this time, I have focused my work on energy policy with the goal of reducing our nation's dependency on foreign energy resources and expanding U.S. investments in clean energy technologies.

Over the past 3 years, the Senate Energy and Water Subcommittee has authorized and appropriated over \$50 billion worth of self-financed loan guarantees. It has invested tens of billions of

dollars into research and development to support the deployment of clean energy technology. Transformation of our energy sector is more than Federal research assistance. It requires billions of dollars in new investment that will only occur if investors believe that markets are stable, provide reliable price transparency and offer the opportunity to hedge their commercial risks.

Prior to joining the Senate Energy Committee, I spent 2 years in the electricity sector. This experience provided an invaluable education regarding the devastating impacts of flawed market design and illegal trading behavior can have on consumers. As a result of this experience, I am resolved to prevent this catastrophe from being repeated.

I joined Mirant in February 2001 as the director of Federal affairs, focused on Federal energy policy. I did not work for a trading desk or for a business unit that managed generation assets. By the time I arrived, it was already apparent the California electricity market was dysfunctional. California had experienced a difficult summer with record energy prices and a blackout in June of 2000.

By November of 2000, FERC had determined that the California market was flawed and making it possible for manipulative trading behavior to cause an imbalance in supply and demand and made the determination that electricity rates were unjust and unreasonable.

In response to the trading behavior uncovered in 2001, I worked with Mirant's chief risk officer and five other energy companies to establish the Committee of Chief Risk Officers. This organization was created to prevent and avoid the trading abuses used by some in the industry to manipulate California and western energy markets.

The CCRO established industry wide trading protocols, improved price disclosure, encouraged clearing and standardized contracts and established a corporate trading code of conduct. These standards would give regulators, consumers and investors a better view of the business and operations of these companies. I do recognize that many of the same reforms implemented by the chief risk officers are now embodied in the financial overhaul proposed by the administration, but on a larger scale.

Both efforts seek to improve transparency of over-the-counter markets, reduce systemic risk and set trading standards to reduce opportunities for excessive manipulation and speculation. A key component of both efforts has been the utilization of clearing to reduce counterparty risks and allocate capital more efficiently.

My experience reaffirms my strong belief that regulators are critical to ensuring that markets operate in a fair and transparent manner. To achieve this, regulators must be provided with the appropriate authority and tools to respond to the constant evolution, market behavior and products.

As I stated in the beginning, I am sensitive to the impacts the financial crisis has had on all families. I understand the consequences to all of us if the markets are manipulated and expose our financial system to greater peril. Drawing on my extensive energy background, I believe I can make a significant contribution to the Commission.

If confirmed, I will work with the other commissioners to ensure markets continue to offer consumers and producers a cost-effective hedge to their commercial risk. I will work to ensure the CFTC uses all the legal authorities to curb excessive speculation and prevent abusive trading practices, including fraud and manipulation.

I would like to thank the Committee for holding this hearing and considering my nomination. It would be an honor and privilege for me to serve on the Commission. Thank you.

[The prepared statement of Mr. O'Malia can be found on page 56 in the appendix.]

Chairman LINCOLN. Thank you, Mr. O'Malia.

Commissioner Sommers, welcome to the Committee.

STATEMENT OF JILL SOMMERS, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Ms. SOMMERS. Thank you, Madam Chairman, and congratulations to you on this historic day for you. I would like to take this opportunity to introduce my husband, Mike Sommers, who is here with me today. I appreciate his support in being here.

Chairman Lincoln, Ranking Member Chambliss and other distinguished members of the Agriculture Committee, I am honored to be nominated by President Obama for another term as commissioner of the Commodity Futures Trading Commission. I have been in this position since August of 2007 and it has been a true privilege to serve the American public as a regulator of U.S. commodity futures and options markets.

During my career, I have had the opportunity to work on agricultural issues for Senator Bob Dole, for a regulated derivatives exchange, as well as for the trade association representing participants in the privately negotiated derivatives industry. I believe this unique experience gives me a diverse view of risk management issues and the knowledge to help implement our core mission at the CFTC.

The Commission applies a strong regulatory oversight program that includes market surveillance to detect and prevent manipulation, as well as ensuring the financial integrity of the clearing process. This risk tailored approach to regulation is complimented by strong enforcement, as evidenced by over \$2.8 billion worth of penalties and restitution assessed in actions brought by the CFTC since the year 2002.

This regulatory regime has enabled the futures industry to experience enormous growth over the past decade. In 2000, the U.S. exchange traded volume was a little over 500 million contracts. In 2009, the volume has increased 180 percent to almost 3 billion contracts. Even with that growth, the regulated futures industry did not endure the loss of any customer funds during the current economic turmoil due to the failure of a futures commission merchant.

Although the regulated futures exchanges and FCMs have performed well throughout the financial crisis, there is widespread belief that the CFTC's regulatory authority should be extended to cover the trading of over-the-counter derivatives. There is broad consensus that more transparency must be brought to these markets.

The current commission is unified in support of comprehensive regulatory reforms, including full regulation of over-the-counter markets. This regulatory framework would cover both the OTC derivatives dealers and the OTC derivatives markets in which they trade.

I believe that we need to enhance transparency and close gaps to improve the regulatory structure. The CFTC has undertaken a number of initiatives over the past year to strengthen our regulatory oversight and enhance public confidence in the markets we regulate.

Under the leadership of Chairman Gary Gensler, we have held hearings to review the application of and exemptions from position limits. We have convened unprecedented joint meetings with the Securities and Exchange Commission to discuss issues of regulation, harmonization and finally, we have implemented two new transparency measures by further disaggregating our Commitments of Traders report and publishing an updated report, Index Investment Data, based on the information we have been receiving through our special call authority.

It is a very challenging time for the Commission and the questions surrounding all of these issues are enormously complex and require thoughtful resolutions. As a commissioner at the CFTC, I believe there is a historic opportunity to reshape the regulatory oversight of financial markets.

If confirmed by this Committee and the U.S. Senate, I will work hard to ensure that the CFTC continues its role of protecting the integrity of the markets while addressing the concerns about the regulatory structure. It is the responsibility of the Commodity Futures Trading Commission to defend the crucial risk management and price discovery functions for American farmers, ranchers, end users and all market participants around the globe.

Thank you.

[The prepared statement of Ms. Sommers can be found on page 61 in the appendix.]

Chairman LINCOLN. Thank you, Commissioner. We will start our 5-minute round of questioning and I will kick that off and then kick it over to my colleague, Senator Chambliss.

But first of all, Mr. Chilton, you have been an outspoken proponent for changes to our current regulatory system. Do you believe that the Treasury proposal regarding the OTC or the over-the-counter derivatives is sufficient to address these regulatory gaps, and if not, what needs to be done to improve upon the Treasury's white papers?

Mr. CHILTON. Thank you, Madam Chair. Yes, I do believe the Treasury proposal is a good proposal. Right now we can't see a whole segment of the market and it does impact price on the regulated exchange, so we are sort of operating with one eye closed.

My view used to be that I wanted to get the information from OTC and then make a determination as to whether or not it was price discovery and we should regulate it. Now I think it needs regulation. Contrary to some of my colleagues and to some senators, I am not 100 percent sure that we need to look at every individual bilateral trade.

Should I care as a regulator about a relationship between a contract, for example, between a farmer and a co-op? I guess if we had unlimited staff that might be interesting, but I am more concerned with the large trades that can impact price and for me, it is really important that whatever we do, if we do something on position limits, that we keep that in mind.

I am not suggesting that we need to get the regulatory authority to oversee the OTC market before we act on position limits, but we definitely need to be thinking about it in a panoptic fashion to ensure that we are making the right balanced and appropriate calls.

Chairman LINCOLN. If the Treasury proposal were to pass this year, what would be the greatest challenges for the Commission?

Mr. CHILTON. Well we got a big staffing challenge in general and I do want to thank the Congress, particularly those that are appropriators also, for helping us out a lot. The SEC has about 3,500 folks. We have about 500 folks.

The market capitalization, the CME group, is larger than the New York Stock Exchange, so we are doing a lot with a little. You know how things work in Congress; you get the authority then you get the people to do it. So there is always that gap 8 months after you pass something, then we are up here explaining why we have not implemented it yet.

So I think the biggest challenge will be actually getting the bodies on the ground to do the work. But I am confident we can do it. We have a great leader in Chairman Genzler and I am sure we can make steadfast progress.

Chairman LINCOLN. Ms. Sommers, Commissioner Sommers, I want to thank you for the work that you have done on the Commission as well. You might, if there is any of those two questions that you would like to comment on in terms of the Treasury's proposal and what you all need most over at CFTC, and then also you might just touch on the career you have had working with both the Chicago Mercantile and the International Swaps and Derivatives. Any of the roles that you had there both with CME and ISDA, how that experience really informed you or informed how you approached the work you do as a regulator.

Ms. SOMMERS. Thank you, Madam Chair. I agree with Bart and believe that the Treasury proposal includes much needed regulatory reform for our financial markets. Two of the main issues included in the Treasury proposal would give the CFTC jurisdiction over the OTC derivatives dealers and markets, along with other regulators, would bring regulation to those markets. It also includes encouragement for central counterparty clearing, which is very important. It brings market discipline and the daily market to market to those transactions.

So I think both the clearing and that jurisdiction is important for us. My experience from both the regulated exchange environment, as well as the experience I have had with the swaps industry, I think is especially important right now. I do support the Treasury proposal's inclusion of jurisdiction over those OTC markets, and I believe for the CFTC to be able to bring transparency to the public about the markets that we regulate we need the transparency from those markets.

Chairman LINCOLN. Great. Mr. O'Malia, just briefly, you did spend, and you mentioned in your opening statement that you spent part of your career working with Mirant Corporation, of course, at a very difficult time in California, and I know there have been recent news articles describing Mirant as an energy supplier and trading outfit that may have contributed to some of those problems that plagued California; would really like to just hear from you.

I think you have great—I believe that you have valuable experience and great experience to be able to bring to the Commission. Would like to ask you to—maybe you would give us an opportunity to discuss the commitment to the Commission and the mission of the Commission in protecting these markets.

Mr. O'MALIA. Absolutely. The California experience, my time at Mirant, was an important lesson. It was a painful lesson for obviously Western energy markets and consumers of California. Many companies were—went into bankruptcy as a result of the markets and it was clear that manipulative trading behavior was employed to take advantage of those markets.

The rules were not right and that exposed the weakness to it. There was not adequate oversight and there was not adequate regulation. I bring that experience to this position and with my eyes wide open and vow never to allow those type of behaviors to begin or occur in those markets and any of the markets.

I think the discussion about the financial overhaul is consistent with many of the reforms the industry tried to make when it was clear that changes had to be made. There was lack of confidence. There was manipulative behavior and they had to put a stop to that. We need to continue those and strongly enforce those.

There is no room for manipulative behavior in any of our markets and I will ensure that I will be very effective and enforceful of those efforts. The Treasury proposal would expand oversight of OTC markets where there was no oversight and we should encourage the use of clearing houses. As both commissioners, it brings a spotlight on it. It reduces systemic risk and everybody has a clear picture of what is going on in those markets and that is very important to see what is going on in those markets.

Chairman LINCOLN. Great. Thank you. Senator Chambliss.

Senator CHAMBLISS. Thank you, Madam Chairman, and I would first like to ask that three letters in support of Mr. O'Malia's nominations from Senators Murray, Bingaman and Dorgan to you and I be submitted into the record.

Chairman LINCOLN. Without objection.

[The information referred to can be found on pages 213-215 in the appendix.]

Senator CHAMBLISS. Mr. Chilton, I appreciate your comments relative to position limits and as you know, I have had a serious concern about what a change in position limits will do relative to not just our domestic market, but the reaction that we might have overseas.

I understand that Chairman Genzler was in Europe last week discussing the need to harmonize a new structure for over-the-counter derivatives trading, but unfortunately, I have seen little coverage of the European regulators' interest in enforcing more

stringent position limits and I know we will talk more about this later. But in fact to the contrary, I note that Commissioner Dunn recently expressed concern that other regulators abroad may not see the need to tighten position limits.

Meanwhile, just the rumor that CFTC is considering tighter position limits and hedge exemption requirements for our own exchange transactions has already lead a large exchange traded fund to seek larger positions in the over-the-counter arena rather than conduct business on exchange. Certainly that is not the intended outcome.

You have suggested that we ought to apply aggregate position limits across OTC in exchange traded positions. But the proof now exists that large market participants faced with limitations will seek creative alternatives and I am concerned it might force them off to exchanges in Europe or elsewhere.

I mean, we may even see other countries develop mechanisms for trading over the counter. How do you propose that the U.S. responsibly apply position limits so as to avoid a migration of markets abroad?

Mr. CHILTON. Well let me say I agree with you 100 percent, Senator, that we need to be very careful how we do this. That is why I say that whatever we do, we need to do it in light of the OTC legislation or the regulatory reform legislation that I hope Congress will consider. It could have the effect, if we are overzealous regulators of moving it to less transparent markets or moving it overseas, that would be a perverse impact to what I think some of us think we need to do.

We have reached the right balance on the ags. As I say, by and large, they have worked pretty well. I know there are some issues that both of us share with regard to some of the specific Ag commodity markets, but by and large, these position limits have worked well for the ags and I think as long as we go into this in a balanced and reasoned way, we can do it so it will not move business off.

That is certainly not something I am interested in. With regard to the Europeans, I think you are right, they perhaps have not been as strong, but I can tell you one thing, Gary Genzler is not a shrinking violet and I know that he has had some pretty explicit conversations with them. I look forward to seeing something public from the Europeans.

But I think in general, as regulators, we sort of need to move in this direction. But we need to be careful, you are absolutely right, about how we go forward.

Senator CHAMBLISS. Both Chairman Genzler and Secretary Geithner and I have had conversations about the fact that we need to bring the Europeans on board. There needs to be some sort of international standard here and whatever we do with respect to the proposed changes in the legislation, obviously, we need to keep that in mind. You guys do not toot your horn enough, but I think it is an absolutely correct statement to say that because of the work in part that you all have done at the Commission from an oversight standpoint, as well as what is going on at the SEC, even though we have had some mistakes that have been made, the markets that you folks regulate did not fail. The markets worked and

Lord knows what would have happened in these tough economic times a year ago if we had seen the markets fail.

But you all did a good job in providing the necessary oversight to ensure that there was no failure and you need to be commended for that.

Mr. O'Malia, over the course of the past few months, we witnessed a breakdown in the financial system and we have heard a great deal about systemic risks. While there are certainly a number of factors that contributed to this situation, many have blamed the lack of regulation applied to the over-the-counter derivatives and some have suggested that regulators of securities and futures need to be authorized to do more.

Obviously we are now tasked with determining what additional authorities are necessary? Rather than tasking various regulatory agencies with duplicative functions and confusing market participants, we should seek to ensure an efficient coordination among regulators. If confirmed, how do you intend to work with other regulators, such as the SEC, to harmonize your respective functions?

Mr. O'MALIA. Both the SEC and the FERC are two agencies that deal with products before the CFTC. I am committed, obviously, to work with those agencies to harmonize the regs to the extent we can. The Treasury proposal did have a joint regulation on mixed swaps.

I think Chairman Genzler did get it right and said we ought to divide those along the lines of expertise and I would support his position on that to ensure that we do not have two regulators trying to solve one problem. Tasking those along the lines of experience makes sense to me.

Senator CHAMBLISS. Chairman Sommers, you currently chair the CFTC's Global Markets Advisory Committee and you have witnessed technological advances leading to a more global marketplace. Some have criticized this evolution in which foreign boards of trade now have greater access to U.S. traders and our U.S. exchanges have greater access to traders abroad.

Could you briefly explain how the CFTC and various foreign regulators coordinate in order to ensure appropriate oversight of the markets across oceans and the borders? I was a little more specific with Commissioner Chilton regarding position limits and how we are going to deal in this arena with our overseas traders and you can expand on that, if you will, please.

Ms. SOMMERS. Thank you, Senator. As you know, foreign boards of trade that wish to offer their products to either U.S. members of their exchange or other U.S. customers must come to the CFTC to get relief in order to offer those products to U.S. customers.

We, in considering this relief for foreign boards of trade, we look at the home country regulator and we look to see if the regulation applied to that foreign board of trade is comparable to what we apply in the United States. We also look to memorandums of understanding that we have signed with their home country regulator. The CFTC is a member of the International Organization of Securities Commissions and we sign a worldwide multi-lateral memorandum of understanding that creates standards and we use that MMOU as a basis for approving those foreign boards of trade as well.

And I think as we look forward on the issue of considering either imposing position limits on our specifically energy and metals complex or the exemptions from those position limits, that it is an issue of concern that we continue to work with our global counterparties to make sure that those are also issues that they are considering, because I do share your concern. If we impose those limits without having our global counterparties in lock step with us, we may have the perverse effect of driving business to other markets globally and making our U.S. regulated exchanges less competitive.

Senator CHAMBLISS. My time is up, but there is one other critical follow-up question I would like to ask you. I know we have a current relationship with the London Exchange on the trading, particularly for oil contracts, where they voluntarily provide us with certain information.

Let me address this to you and Commissioner Chilton. Are you folks satisfied with the information that you are getting from the London Exchange on these contracts?

Ms. SOMMERS. I think, Senator, that that is a perfect example of how well our foreign board of trade regime has worked. This year, we have made significant modifications to our memorandum of understanding with the UK FSA in order to address that linked contract that is listed on a foreign board of trade that is priced off a U.S. contract or settles to that U.S. contract.

We have made modifications to that memorandum information sharing, as well as with the enforcement authorities, so we do get large trader data on a daily basis from that exchange, as well as have other information sharing agreements and enforcement availability with that agreement.

Mr. CHILTON. Yeah, I would echo what Commissioner Sommers said. I am satisfied. We get it on a daily basis. It is in real time. It is in the same format. We actually print it in our Commitment of Traders report, so it is very helpful.

It would not bother me if it is codified. Now it is this thing we call a no-action process and it is a little convoluted. As Commissioner Sommers said, we have worked it out and I think everything is fine now. But I would not mind having—if we are doing—if you all are doing regulatory reform, having it codified by a statute. But it is working well now, Senator.

Senator CHAMBLISS. Thank you.

Chairman LINCOLN. Senator Lugar.

Senator LUGAR. Thank you, Madam Chairman. Commissioner Chilton, I think you were present perhaps about a year ago when we had a hearing of this Committee. On that occasion, we had a witness that tried to describe to the Committee what was occurring in the financial crisis.²¹ Anecdotal, you went through the situation where the local banker was out there trying to get a lot of the mortgages on the books. Having collected all these, these were packaged. It was sent on to another bank, sometimes sold, and folks were out of it altogether locally, packaged again and moved on somewhere else.

Now finally, at a level of some bank or institution, it had a lot of these packages. It was explained you go to a place like AIG to get insurance and you get insurance through derivatives, let's say. So then we, as amateurs, sort of press, what kind of derivatives are

these? Well some look fairly straightforward. This is an insurance derivative. But then one witness add, but you could also express opinions.

And so he said, is this like an opinion poll in addition to an insurance policy? He said, well not exactly, but for example, you might bet on the fact that the banking system of Pakistan was going to fail and as a result, even though it has nothing to do necessarily with what the flow had been thus far, if it failed. You might get a payoff, or as some of the other insurance situations, it might not work out, including maybe AIG being able to pay you.

This came as a surprise to many members as to what kind of statement or ink on paper, and so we got into this situation that these derivative functions are not all ones in which you know the parties, the party or the counterparty, or as a matter of fact, we then had, some of us, visits from bankers who said, now as you begin to think about regulation, do not pin this down. We need to have a lot of creative space to write these situations. They are not all the same.

We are talking about clearing not identical contracts, very different. This is not very reassuring to those of us who are citizen amateurs of this quite apart, I think, from the financial community, and we are still, as you pointed out, although CFTC always was thought of by many as having agriculture commodities, the financial instruments became very large in your situation quite apart from the energy situation, which in the last reauthorization of CFTC somehow got omitted or had not the same weight.

This is all the beginning of a question. What in the current CFTC proposals or laws that Treasury is offering, or anybody is offering, finally brings us into some clearing function of counterparties where we actually have, even complex as it is, something that is relatively uniform as opposed to totally creative in ways that—once again creative bankers, financial people and so forth, in a search, in our American free enterprise system for wealth, blow the whole thing out; can you give us some reassurance?

Mr. CHILTON. I can give you some, Senator, although I am not going to vouch for that entire situation you described, because I had some of the very same concerns. It was the Commodity Futures Modernization Act, which codified that we would not be regulating swaps and these credit default swaps that you are talking about really metastasized throughout the banking and the trading community. It would have been difficult to follow even if you re regulating them, but certainly unregulated they lead to many of the problems that you describe, in particular AIG.

It is all hindsight now, but I venture to say that if credit default swaps were regulated, that may not have happened. And so I think it is one of the things that you described, Senator Lugar, that was probably a mistake in CFMA. In my view, there are many good things in CFMA. It has allowed the free market to flourish, to be innovative and look around the corner and be competitive. But that is one of the things that I think was an inadvertent policy.

The administration has called for regulation of these types of swaps. It has sort of left the door open.

to who would regulate them, whether or not it would be the CFTC or the SEC. In my view, as a CFTC regulator, it would be

easy to just say well we should have it. But to be honest with you, I just care that it is regulated. I just want to make sure that somebody is looking at this.

We can do it. Again, we need staff to do it. And we can do a competent job, but I think for American consumers, it is just important that somebody who comes before you all, or another committee who is responsible for this type of thing, looks at it very hard and carefully and always has in the back of their mind, how are we protecting consumers? How are we protecting markets?

Senator LUGAR. Well this begs then my second question and that is, perhaps you do not have control of this now or oversight. Maybe you will. You certainly do have all of the energy situations and the Ag is a very small part, as you have said.

Now last year at this same time, the complaint was made that the staff problems at CFTC, even with what you had, were totally inadequate in terms of number of people. There were senators piling on about speculation and all the difficulties and you and the chairman, what have you, were saying well, give us some people.

Now you intimate you do not have the people yet. I am trying to sort of fathom where in the system you get the people. Have you requested them? Are they in somebody's appropriation authorization bill or anyone in the stream at this point?

Mr. CHILTON. Yes, sir. We have—I cannot give you the specific numbers, but I said we were at 500 in my oral remarks. I think we are going to actually be closer to 600 like today, maybe 599, and we have a request in for more. I cannot give you the exact amount, but we are moving forward. We are now at the Financial Services Ag—or the Financial Services Appropriations Subcommittee.

But with the support over the years, we have done a lot better. But as I say, we have a big workload out there and depending upon what happens with some other issues, for example, carbon trading, if that ends up passing and we have that, that could be the largest commodity market, physical commodity market in the world.

And so I appreciate the question and appreciate the support, Senator, and we are going to continue to need it as we go through the appropriation cycle. But we have requested it so far and I think we are moving in the right direction.

Senator LUGAR. Thank you. Thank you.

Chairman LINCOLN. Senator Cochran.

Senator COCHRAN. It occurs to me, Mr. Chilton, listening to your testimony and expression of concerns about the inadequacy of the power or authority of the CFTC, that you are making an argument for additional definitive powers and responsibilities that would be defined by Congress and enacted so that you could do the things that you are saying ought to be done.

Is there an issue now between this agency and other agencies or departments of the government where they are also seeking that kind of definitive acknowledgement of power and responsibility? What is the state of play in the definition of legal authority?

Mr. CHILTON. Well with regard to what Senator Lugar was asking with regard to clearing and swaps, particularly credit default swaps that were \$55 to \$60 trillion, I mean just a monstrous number, the SEC is also interested in that and really I think the ad-

ministration deserves to be commended by coming out with such a strong proposal and doing it fairly on.

But in all candor, they punted on the question of whether or not it was going to be the jurisdiction of this Committee or the Banking Committee and again, it would be easy to say turfs, that we should do it here, but as long as it is done. And so I will leave those important decisions to you and other senators.

Senator COCHRAN. That is reassuring, and that you are not about to go out and start regulating and start bringing in people and start finding violations of the law as a commission, as an administrative body, without the color of that authority.

Mr. CHILTON. Yes.

Senator COCHRAN. You do not have that in your background as an inevitable conflict that you are going to have if you are—

Mr. CHILTON. No, I do not, Senator. I mean, I think there are some things we can do through the rulemaking authority with regard to position limits and hedge exemptions, but again, we need to do that with a view toward the unregulated markets and we need to do it, as I was discussing with Senator Chambliss, in a way that does not send markets—it does not send current regulated traders to unregulated markets or does not send them overseas.

So we need to be very careful about this, but my colleagues are smart folks. We are going to get this right. We are going to do the same types of things that you all do every day and make sure that we are not losing markets and make sure that we are protecting consumers.

Senator COCHRAN. Well, do not use us as a role model.

Mr. CHILTON. I know you too well, Senator. You have done a lot of good work over the—

Senator COCHRAN. Individual senators are different from the body as a whole.

[Laughter.]

Senator COCHRAN. Thank you very much for agreeing to serve in these positions. This is going to be a very challenging period, I think. I think the Committee will do well to follow very closely how all this plays out. Thank you.

Chairman LINCOLN. Be assured, Senator Cochran, we will be, as a Committee, following very closely in terms of what the responsibilities—and you are right, it is a tall order at this juncture in our economy and in the world economy, so we will definitely be following closely.

Senator Thune.

Senator THUNE. Thank you, Madam Chair, and congratulations to you on your historic accomplishment, first woman and first Arkansan as the chairman of this great Committee. Your style and approach to dealing with issues will serve this Committee and its members and the entire Senate very well, so congratulations and just do not forget about us northerners up there. We will bring you up to South Dakota to give you a chance to visit somewhere soon.

Senator COCHRAN. We learned our lesson.

[Laughter.]

Senator THUNE. All right. On a more serious note—

[Laughter.]

Senator THUNE. Let me, if I might, just pose a question to whom-ever, maybe to Commissioner Chilton to start with. But if the Congress were to require mandatory reporting for all OTC transactions, what additional resources would the CFTC need to manage such a large amount of data? And maybe Commissioner Sommers could answer.

Mr. CHILTON. I do not have an exact number, Senator Thune, but it seems to me that, as I said, 3,500 or thereabouts with the SEC, 500, 600 at the CFTC. I would like to see us up in the 700 full-time equivalent positions in the not too distant future, and that is without anything with regard to carbon.

So we could use another 100 people sort of pdq and I think we need to continue to request more and ramp up. You know, there is a limit to how large we should get certainly. We do not want to be overly bureaucratic, but right now, as Senator Lugar described, we have a lot of challenges that we just are not up to, and it is not because we do not have dedicated and resourceful and professional staff; we do.

Senator THUNE. Anything to add?

Ms. SOMMERS. Senator Thune, I think we have to continue to consider that the OTC markets are large and they are very complex and they are markets that the CFTC does not have experience in regulating. So it is something that will be an enormous task for us.

But as Commissioner Chilton noted, we have hired, I think, almost 100 people over the last year and if things progress the way that we hope with the budget this year, we will be able to do the same next year, and that will be very helpful for us, not only with actual bodies on the job, but with advances in technology to help us survey all those markets as well.

Mr. O'MALIA. Senator, if I may, the people are important. Working in the appropriations, we have had the opportunity to work with our national labs and see what technology can do for us, specifically world class computing. It seems to me we also—there is a technology element that we have to stay ahead of the markets, or at least keep up with them. The investment in that category has been woefully inadequate.

We really need to focus on taking advantage of the high speed global nature of these markets and avail ourselves to the technology. If confirmed, I would be happy to take that effort on to find out what opportunities we can do to keep up. Keeping up would be a good start.

Senator THUNE. One of the—if climate change legislation were to pass, it would allow third parties like banks and foreign nations to participate in the carbon market. In other words, you would have third parties that are not directly associated with carbon. Offsets would be able to purchase these credits on an exchange.

In your opinion, does that leave the carbon market open to undue influence or manipulation and is it possible under a scenario like that that a third party investor or group of third parties would be able to drive up the price of carbon by purchasing large amounts of allowances or available carbon credits?

Mr. CHILTON. It is a concern that has been raised particularly recently in the last several months that I have heard. You know, we

have, like I say, professional staffs. I think we can do the regulation of this, as long as we have the authority.

Some have argued that the smaller the markets, the easier it is to regulate and while that is true, I would rather have deep liquid markets with lots of trading and you go back and forth between people at the agency center. Some will say it is just another contract. It is just like crude oil.

It has its distinct difference in that the government would, under the legislation proposed, actually control the allocation. And so that is different. But by and large, I am not worried about the size of it as long as we have the resources to police it. I think we can do a good job. And as I say, I think it can have an enormous benefit not just for whatever it can do for the environment, but I think it can add to the economic engine of our democracy, and that is not a bad thing.

Senator THUNE. What role would you see speculators playing in a carbon market and how would you define a speculator? How would you define excessive speculation?

Mr. CHILTON. Right.

Senator THUNE. I mean how would you go about—

Mr. CHILTON. I like speculators. Too often I think speculators get branded as sort of a dirty word. We are going to need people involved in these markets to ensure that they work and I think if you only have commercial participants, the markets will not function as efficiently or as effectively as a lot of us would like.

But we will need to be careful to ensure that there may be—it may be appropriate for example, to put certain limits. Just like we were discussing position limits in the energy and metals complex, I think that is probably appropriate for carbon, to avoid the very things you are asking about.

Senator THUNE. Mr. O'Malia, you are the new guy. What do you think about derivative products being forced onto regulated exchange?

Mr. O'MALIA. We do—the administration has put out a very comprehensive proposal and I believe the transparency and reporting requirements to move more of these products into regulated markets is an important move. Increase, avail ourselves to clearing would be critical, but we do not want to shift everything—standardize everything for the sake of standardization.

We need to make sure that these actually pose a risk of manipulation or threat and that they could impact the overall pricing of commodities. And I agree with those principles. More trading on regulated markets would be helpful. We will be able to see it. We will have clear—it will be priced to the market. They will understand it better and it will be more useful.

Clearing reduces risk and that is helpful. We do not want to make this too costly, however, to make sure the people—everybody who has commercial risk cannot use these. They have to be available.

Senator THUNE. Commissioner Chilton, Commissioner Sommers, what reaction have any of you received from market participants about the administration's proposal to impose capital requirements on dealers of OTC derivatives?

Ms. SOMMERS. Senator, I think that the capital requirements provisions that is in the Treasury proposal is consistent with the capital requirements that we look at in the futures markets. We are also moving forward in the futures markets to impose additional capital requirements on the FCMs in our markets to make sure that is part of our job, to make sure that that risk surveillance and part of what an FCM has in the clearing process is adequate and it is something that we are very mindful of. I have not heard any of the dealers or market users express any concerns about this.

Mr. CHILTON. I agree with Commissioner Sommers and only echo what some of the other senators said and that is that these markets really were not at the heart of the credit crisis and the recession, and you all should take great pride in that.

I mean, we have worked pretty well. This is just a good time for us to think about other sideboards that we may need to put on the law and rules and regulations where appropriate to make sure we continue down that path.

Senator THUNE. Madam Chairman, thank you and I would like to be able to be here for our next panel. I want to hear Mr. Avalos tell us how he is going to get the Ag community united on animal I. d., but I probably will not be able to be around for that.

So thank you all for your willingness to serve, of all of our nominees today, and thank you, Madam Chair.

Chairman LINCOLN. Thank you, Senator Thune. Do any of you all have additional questions for this panel?

Well before I dismiss them, I would like to—one last item for the nominees. As you know, Senator Cantwell has played a leadership role in the Senate with regard to commodities futures regulation and has some questions that I will be submitting for the record.

I know all of us look forward to your responses there and you will have ample time to be able to respond to that and to Senator Cantwell's questions. So thank you again. I echo the words of my colleagues. Thank you for offering yourself in terms of public service. We have a lot of challenges ahead of us.

We are going to be looking to the CFTC for great guidance and opportunities to really grow our economy, but do so in a way that minimizes risk and certainly ensure confidence in the American public. So we appreciate your being here today and we appreciate your willingness to serve.

We will excuse this panel and we may ask the—invite the second panel to come before us.

Senator CHAMBLISS. Madam Chairman, while this panel is coming up, let me just recognize one of my staff that you know well whose probably last hearing is going to be today. Vernie Hubert has been a member of my staff the whole time I have been here in the U.S. Senate and I first got to know Vernie when he worked for a Democratic congressman—

Chairman LINCOLN. I did too.

Senator CHAMBLISS.—Charlie Stenholm, who was such a great advocate of agriculture. I had the pleasure of working with Vernie on both the 1996 Farm Bill and the 2002 Farm Bill and then obviously this past year over here. Vernie has just been such a great asset to the Committee for so many reasons and a particular asset to my staff because of his knowledge of agriculture, his commit-

ment to ensuring that we do the right thing for farmers and ranchers.

He is a guy that we are truly going to miss here. I did not want to let today go by. We have encouraged him and drug him back over here. I would not let him go home last year as soon as the Farm Bill was completed and he has graciously agreed to stay on here this past year. I just want to recognize Vernie as a true asset both to me and to the Committee and particularly publicly to thank him for his service.

Chairman LINCOLN. Well, Senator Chambliss, I would like to join you in that and I too first met Vernie when I was in the House. I would say that his leaving at this juncture is subject to the discretion of the chair.

[Laughter.]

Chairman LINCOLN. So I do not know, but if I am going to exert any powers, this might be the place to do it.

Mr. HUBERT. Can I have you talk to my chairman?

[Laughter.]

Chairman LINCOLN. Well we do appreciate the incredible work that Vernie has put forward on behalf of American agriculture and he has done a tremendous job. All I can say is, please do not go. But we are grateful to him, and grateful to him and grateful to you, Senator Chambliss, for having him on board. He was an enormous part of the negotiations that we had on the Farm Bill and was a real calming effort there and did a tremendous job of pulling people together and we appreciate it.

So I am still going to reserve my right as chairman to have a say in that, but anyway, I know your chairman and I know she will trump me, so nonetheless.

If I can ask this panel to please stand. I am not sure if we all got the swearing in, but I am not going to mess it up on my first watch, that is for sure. If you will raise your right hand.

Do you swear to tell the truth, the whole truth and nothing hut the truth?

Mr. AVALOS. I do.

Mr. SHERMAN. I do.

Mr. SPEARMAN. I do.

Chairman LINCOLN. Great. Our mandatory question, do you agree also that if confirmed you will appear before any duly constituted committee of the Congress if asked?

Mr. AVALOS. Yes.

Mr. SHERMAN. Yes.

Mr. SPEARMAN. Yes.

Chairman LINCOLN. Great. Thank you. Thank you, gentlemen, for joining us today. We appreciate it and appreciate your willingness to also serve. We would like to begin by your statements, if we may, and then we will enter into our questioning.

Mr. Avalos.

STATEMENT OF EDWARD M. AVALOS, NOMINEE TO BE UNDER SECRETARY OF AGRICULTURE FOR MARKETING AND REGULATORY PROGRAMS AND MEMBER OF THE BOARD OF DIRECTORS, COMMODITY CREDIT CORPORATION

Mr. AVALOS. Chairwoman Lincoln and ranking member.

Chambliss, members of the Senate Committee on Agriculture, Nutrition & Forestry, thank you for the opportunity to appear before you today.

Chairwoman Lincoln, I also would like to congratulate you on your new assignment to chair this Committee. I know that the folks back in Arkansas are really proud of you.

Chairman LINCOLN. Thank you.

Mr. AVALOS. And also, this being your first hearing for this Committee where you are in the leadership, I am honored to be a part of this historic event. I am extremely grateful to President Obama for nominating me and Secretary Vilsack for his support.

If I can, Madam Chair, I would like to introduce members of my family.

Chairman LINCOLN. Please do.

Mr. AVALOS. I think I am going to read it, and then they can just—anyway, I have my better half, Anna Bee, from Mesilla, New Mexico; my daughter Alexandra and her fiance, Tom. They are from Long Beach, California. My daughter Megan and her fiance, Mark, from Phoenix, Arizona; and of course, my son, he is my fishing and hunting buddy, Russell, from Las Cruces, Mexico. I also have quite a few friends that came all the way from Las Cruces, well actually from all over New Mexico, to be here with us.

Chairman LINCOLN. That is wonderful. Please stand so we can welcome you to the Committee.

[Applause.]

Chairman LINCOLN. That is quite a cheering squad.

Mr. AVALOS. I almost have a basketball team.

Chairman LINCOLN. That is right.

Mr. AVALOS. Madam Chair, members of the Committee, it really is an honor to be nominated to serve as the under secretary for marketing and regulatory programs at the U.S. Department of Agriculture. The mission includes the Agricultural Marketing Service, the Animal and Plant Health Inspection Service and the Grain Inspection Packers and Stockyards Administration.

Each of these agencies are extremely important and contributes to benefit the agricultural industry all the way from the producer through the shipper, the processor, the retailer and on to the consumer.

I grew up on a family farm in the Mesilla Valley in Southern New Mexico. At an early age, my parents, Adolfo and Eva Avalos, they instilled a very strong work ethic which I have followed through my entire career. My 30-plus years of experience in agricultural marketing have prepared me for my role as the under secretary. I have worked with the agricultural industry to address regulatory, marketing, production and other issues and challenges in both the national and international arenas.

I am a firm believer that the U.S. agricultural sector has been and continues to be the backbone of this country, providing food and fiber to consumers and end users in the U.S. and also in markets all over the world. During my career, I gained considerable experience in both the international and domestic arena. I have worked to support the production and marketing of livestock, specialty crops, value added products to the implementation of trade missions, dialog and promotion.

Also I have worked with diverse stakeholders to develop and establish and maintain markets for sheep, cattle, goats and numerous fruits and vegetables in Mexico, onions and processed foods to Canada, and most recently, the pecan growers' success in creating an export market in China.

In the domestic arena, I have been very successful in establishing markets for chili peppers, onions, potatoes, watermelons, pumpkins, pecans, beans and alfalfa. I have worked closely with producers to support the production of crops that the industry demands. I worked with the distributors for timely delivery of goods and with retailers to showcase, promote, sell, educate and inform the consumer utilizing brochures, recipes and other promotional and educational tools.

In addition, I have worked to advance Indian agriculture, including working closely with the Navajo Agricultural Products Industry. This is an 85,000-acre farming enterprise located on the Navajo Nation in the four corners area of New Mexico and with some of the Indian pueblos in Northern New Mexico to bring back traditional agriculture to their tribes.

I believe it is important to create an atmosphere of collaboration and foster good communication through agriculture production. I am enthusiastic about opportunities to promote fresh and local availability of products, more farmers markets, trade organizations and better connecting the American public with their food supply.

As a result, I have established an effective and informative network of growers, shippers, trade organizations and other stakeholders throughout the country. I have worked closely with the North American Agricultural Marketing officials, the National Association of State Departments of Agriculture and the Western United States Agricultural Trade Association. This network provides me with needed input on issues and trends within the food, agricultural and livestock industries.

If confirmed as the under secretary for marketing and regulatory programs, I will emphasize providing oversight of the three agencies and addressing the concerns of agricultural boards and commissions. If confirmed, I look forward with enthusiasm to stimulating employee morale and working with the many fine public servants which are assigned to my area, as well as the other agencies within USDA.

I am strongly committed to civil rights at the department and will work hard to ensure USDA's employment practices will not tolerate any form of discrimination, but instead will create a positive environment that celebrates and draws upon the strength of USDA's diverse workforce and consumer base.

If confirmed, I am committed and dedicated to working with Secretary Vilsack and this Committee to address and resolve the many concerns and difficult issues that are facing the food, agriculture and livestock sectors of this country. Building on my experience with the farmers, with the ranchers, dairymen, with the shippers and brokers, the food processors, the distributors, retailers and consumers, I will provide the leadership and guidance needed to implement the Farm Bill and carry out the mission of USDA.

Thank you for your consideration and I am happy to respond to any questions.

[The prepared statement of Mr. Avalos can be found on page 48 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Avalos.
Mr. Sherman.

STATEMENT OF HARRIS D. SHERMAN, NOMINEE TO BE UNDER SECRETARY OF AGRICULTURE FOR NATURAL RESOURCES AND ENVIRONMENT AND MEMBER OF THE BOARD OF DIRECTORS, COMMODITY CREDIT CORPORATION

Mr. SHERMAN. Thank you, Madam Chairman. It is a great honor to be here before this Committee today considering my nomination for the position of under secretary for Natural Resources and the Environment. Let me add, Madam Chairman, to the chorus of congratulations to you. I very much look forward to working with you and all of the members of the Committee.

I want to thank my senator, Senator Bennet, for his very kind words of introduction. He is doing a wonderful job with our national forests and our conservation programs, so I appreciate his kind words. And although I brought a somewhat smaller cheering section for me, I wonder if I could introduce my family.

My daughter, Jessa Sherman, from Los Angeles; my brother, David Sherman, from Denver; my sister Barbara Kailey, from Denver; and my niece, Shawn Kailey Reagan, from Los Angeles. If you could all stand up.

[Applause.]

Mr. SHERMAN. Several weeks ago when I received the news that President Obama had nominated me, I was deeply humbled by the honor, but also by the degree of responsibility that accompanies the position. I fully realize that the challenges ahead will not be easy, but it is an extraordinary opportunity to do good for our country.

If confirmed, I promise to use my strengths, energy, commitment and good judgment to advance the conservation and public land programs that will fall under my jurisdiction and I promise to work closely with you and the other committees of Congress as we go forward.

My interest in overseeing the Forest Service and NRCS stems from a lifetime of experiences with public lands and conservation programs. As a child, my parents took me to the mountains outside of Denver where we would camp, hike, fish, ski and jeep. These experiences left an indelible impression on me of the grandeur and the importance of our national forests.

Later I have twice had the privilege of serving under two Colorado Governors, Governor Richard Lamm and Governor Bill Ritter, as the director of the Colorado Department of Natural Resources and I have had the opportunity of working on a daily basis with the Forest Service and other Federal land management agencies on very interesting, complex resource issues. Between these two stints as DNR director, I have represented as an attorney both public and private sector clients in their dealings with Federal land management agencies.

These experiences, combined with earlier work I did with the State Soil Conservation Service, and my later work with many land trust conservation organizations, have given me a background that I believe will serve me well in this new job. Looking forward, there

are tremendous challenges regarding our forests, both Federal and private, and the conservation programs associated with farms and ranches throughout the country.

On the forestry side, many forests are in trouble due to past fire suppression, increase in fuel loads and changes to our climate. As a result, many forests are far more vulnerable to catastrophic fire, disease and invasive species, often in epidemic proportions, such as the situation that we face in Colorado where we have several million acres of dead trees due to Pine Beetle kill.

We are witnessing far more frequent, intense fires. Combining these factors with a growing human population influx within or adjacent to our public and private forests, it is clear that we have a very challenging situation ahead. How we protect our growing communities from fire danger, how we protect the watersheds within our forests that supply drinking water to much of our population, how we protect wildlife species that rely centrally on these forests, and how we ensure that our forests play a critical role as carbon sinks is a herculean responsibility.

I believe that Secretary Vilsack's emphasis on restoration of our forests, both Federal and non-Federal, in a manner that addresses climate change, environmental protection, identifies new markets for wood products, creates jobs and sustains rural communities, provides an excellent framework for moving forward.

It is also important that we take a holistic approach to land conservation. On the NRCS side of the ledger, I have much to learn, but I am very excited by the mission and the scope of the agency's charge. Conservation of private working lands plays a significant role in protecting water resources and wildlife habitat, creating jobs and providing economic opportunities for rural America.

NRCS's watershed protection program helps communities from floods like those that we have just seen in Georgia. With these comprehensive programs, on the ground expertise and powerful technical tools, NRCS is well positioned to help private landowners play a significant role in addressing a variety of the nation's conservation challenges.

So in closing, let me just say, together the Forest Service and NRCS can make a major difference. Never before have agriculture and forestry been more at the forefront of current national policy issues. This is an urgent time to make progress. I am excited by the prospect of devoting my energies to these tasks.

I promise you that if confirmed, I will undertake collaborative efforts involving appropriate stakeholders to find common sense solutions and to come up with answers that will withstand the test of time, becoming durable, long standing and reliable programs. Thank you, Madam Chairman.

[The prepared statement of Mr. Sherman can be found on page 59 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Sherman.
Mr. Spearman.

**STATEMENT OF KENNETH ALBERT SPEARMAN, NOMINEE TO
BE MEMBER OF THE FARM CREDIT ADMINISTRATION
BOARD, FARM CREDIT ADMINISTRATION**

Mr. SPEARMAN. Thank you, Madam Chairman Lincoln and Ranking Member Chambliss and the distinguished members of the Committee. Senator Lincoln, congratulations on assuming the chairmanship of the Committee. I look forward to your leadership and working with you and Senator Chambliss and this Committee for the betterment of American agriculture.

I also want to thank Senator Nelson for his kind and generous introduction. He serves my home state of Florida in the U.S. Senate with honor and distinction. If confirmed, I will keep the trust of his example of public service to our country.

It is a privilege to appear before you today as President Obama's choice to serve as a board member of the Farm Credit Administration. This is a special honor for me and I am honored that my family also is here to share it with me. We all achieve success in life with the help of others. I am no exception, so I especially want to acknowledge my wife, Maria, my twin daughters, Michelle Springs of Orlando, and her sister, Rochelle Puccia, of Los Angeles, and my son, Dr. Kenneth Spearman, of Long Branch, New Jersey.

Chairman LINCOLN. Please stand so we can greet you.
[Applause.]

Mr. SPEARMAN. It is indeed an honor to be nominated to this prestigious position. I would like to share my background and tell you about the skills and experience I would bring to the Farm Credit Administration Board should the Committee confirm my nomination.

As an accountant, I was involved with the development of a public accounting firm in Chicago, Illinois and later worked as an accountant for a major accounting firm. From 1980 to 1991, I served as controller of the Citrus Central, Inc., where I was responsible for the financial management and reporting for this \$100 million agricultural cooperative.

Until recently, I was director of internal audit for Florida's Natural Growers, Inc. There I was responsible for the design and implementation of the annual plan, which was used to appraise the soundness and adequacy and application of accounting, financial and internal operational controls.

I currently serve as an independently appointed outside director on the board of AgFirst Farm Credit Bank, a position I have held since January 2006. As you can see, my professional history, most of my career has been spent working for agricultural cooperatives. During my 28 years in the citrus industry, I gained a deep appreciation for agricultural producers and production agriculture.

As the members of the Committee are well aware, production agriculture, particularly Florida's citrus industry, is capital intensive and heavily reliant on access to a competitive credit. Add in the variables of the marketplace, world events, weather and many other unforeseen factors, and one can see that agriculture is a risky business.

Americans, and for that matter, people around the world should be thankful for the men and women who produce the food and fiber that we enjoy daily and without which we could not survive. As I

said, production agriculture is very capital intensive. Land costs, labor, equipment and fertilizer require long-term and short-term financing. It takes a variety of lenders to meet the credit needs of agricultural producers and their cooperatives.

The Farm Credit System, which is regulated by the Farm Credit Administration, is a very important part of that coalition of lenders required to finance American agriculture. Serving as an outside director of the AgFirst Farm Credit Bank board has given me a new and greater appreciation for the complexity and importance of agricultural and rural finance.

I believe my 28 years of financial experience working for agricultural cooperatives will serve me well as a member of the board of the Farm Credit Administration. I would utilize that expertise to ensure the safety and soundness of the Farm Credit System so that it continues to serve the credit needs of America's farmers, ranchers and their cooperatives.

In closing, I would like to thank the Committee for the important role it plays in the oversight and authorization of the Farm Credit System and its mission to meet the credit and related services needs of America's farmers and rancher.

That concludes my statement and I will welcome any of your questions. Thank you.

[The prepared statement of Mr. Spearman can be found on page 63 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Spearman. I also note that we have another of the FCA board members here with us today, Nancy Pellett. Hey Nancy, welcome to the Committee. We look forward to working with you.

Just a few questions for this panel, if I may. Mr. Sherman, this administration is committed to reducing our dependence on imported oil and natural gas, coal-fired power plants in this country for our energy. Biomass can be converted into energy and fuel, reducing our dependence on fossil fuels and certainly our carbon footprint.

What role do you see USDA and the Forest Service playing in this new initiative, and as under secretary, how will you expedite the decisionmaking and the other processes necessary to get the expected results in a timely manner?

Mr. SHERMAN. Senator, I think both the Forest Service and NRCS have a very important role in exploring the possibilities of biomass to deal with the country's energy security. Obviously our forest products are potentially a form of energy that can be used to provide for heating materials, potentially for electricity, for fuels and I think the Forest Service clearly owes it to itself and the constituencies it works with to actively explore how we can use these materials to provide for potential future energy resources for the country.

And I think the same goes for NRCS. Clearly, there are all kinds of opportunities with our private forest lands and with the crops that we are growing in this country to address potential markets and opportunities. These are great for conservation. I think they are terrific opportunities for jobs and for rural development. If I am confirmed, I will work very diligently in this effort.

Chairman LINCOLN. I appreciate that and I hope that you will continue to share your vision of how NRCS and the Forest Service can work together to really provide the kind of—private forest landowners with the assistance they need in managing their lands and certainly in terms of the decisionmaking. I know it—often times it definitely takes time, but sometimes expediting that can really be a big help.

I am also from a rural state and a primary concern of mine is the state of rural forested counties. In 2008, we reauthorized the Secure Rural Schools in Communities Act, which helped provide critical funding for schools, roads and forest management that contributed to strengthening the economies of these rural communities.

If authorization expires at the end of 2011, the funds for schools and counties will drop by more than 50 percent, which could be devastating. We had here, well a group meeting yesterday of rural educators basically, but the foresight of that would just be devastating to many of our rural schools across the country. This would be a huge blow to those communities.

Are you familiar, Mr. Sherman, with the SRS and do you support its reauthorization?

Mr. SHERMAN. Madam Chairman, I am not familiar with this program yet, but I promise you that I will become familiar. If I am confirmed I will look into it actively and I will get back to you on that.

Chairman LINCOLN. Please do. There is a disproportionate share of our children in this country that do attend rural schools and certainly that combination of what the Forest Service and others do in those counties and how it affects those schools and the ability to educate our children in rural areas of the Nation is really, really critical.

Last, just maybe you might share with us your experience in Colorado developing the state's roadless rule and how that might affect your handling with that issue nationally?

Mr. SHERMAN. Well first of all, let me just reemphasize my personal commitment to protection of the country's roadless areas. This is an extremely important asset to our current generations and to future generations in the United States. As a personal matter, I believe very deeply in the importance of this resource going forward.

I do want to say that because I was involved in the preparation of a Colorado roadless petition under the Administrative Procedure Act, in my discussions with USDA officials, I think it is appropriate for me to take myself out of consideration of reviewing and rule that I helped to prepare.

So I am sure that the secretary will designate someone else in the department to review the Colorado petition as it comes forward. But the president has stated his very clear desire to protect roadless areas in this country. Secretary Vilsack has as well. I am anxious to sit down with the secretary and his staff to review what strategies and what approaches they will be using going forward.

I have not yet had that opportunity, but I am looking forward to that and if this Committee wishes to talk further about that after

I have had these briefing opportunities, I would be happy to come back and discuss it with you.

Chairman LINCOLN. Thank you. We look forward to many discussions. Obviously, as under secretary of agriculture for Natural Resources and Environment, there is a multitude of issues that are covered there that particularly affect our rural states and they are important. Things that—I will be honest with you, and I do not know how my colleague feels, but I get hit with them every time I go home, which are questions in regard to everything from wetlands and wetlands reserve programs, as well as the rural schools initiatives and other things like that. So those are important issues to our constituents and you will definitely hear from us a great deal in terms of many questions that we will have.

I know my time is running out. I just wanted to touch briefly with Mr. Spearman. As our nation is recovering from financial crisis, there has been much discussion about regulatory reform. We heard it from the previous panel and oversight of the financial institutions.

I certainly strongly believe that the Farm Credit Administration Board needs qualified individuals who can be independent and objective regulators and we look forward to that. If you could share with us your qualifications and capabilities that you would bring to the job to be an independent, objective and conscious regulator of the Farm Credit System and Farmer Mac.

Mr. SPEARMAN. Thank you, Madam Chairman. My experience after graduating from Indiana University was to work for a public accounting firm and as an auditor in a public accounting firm we learned extensively how to actually go into a company, a company that was actually paying you for that job, and to act as an independent auditor.

Following that experience, I moved on to an internal audit position ultimately with Florida's Natural Growers, where I actually worked for Florida's Natural Growers, but my job was to actually put myself outside of the management of the company and to observe the operations, both financially and operationally, as an independent objective auditor.

And moving on to the AgFirst Farm Credit Bank after my retirement from Florida's Natural Growers, I was actually brought on that board as an independent outside director. I do not have farming experience, if you will, other than the experience that I have gotten visiting farms nationally from farmers who have invited my wife and I to experience what actual farm life is like.

So as a result of that, I have—I believe that I can kind of put myself outside and observe the system and act as an effective regulator.

Chairman LINCOLN. I just think it is important to give you the opportunity because as an appointed director—but you did qualify as an independent appointed director on the board?

Mr. SPEARMAN. That is correct.

Chairman LINCOLN [continuing]. Of the AgFirst Farm Credit Bank—to give you an opportunity to really visit about your ability to be impartial in that.

I know our auditors here, whether it is CBO or the JCT and others, as auditors they are non-partisan and certainly not partial.

They just count the beans and tell us how the cow ate the cabbage is basically what they do for us. But it is important as we create legislation to have that and certainly I think it is important to have that independence.

Senator Chambliss.

Senator CHAMBLISS. Thank you, Madam Chairman. Mr. Avalos, as under secretary for Marketing and Regulatory Programs, you are going to be responsible for regulatory decisions, obviously in a very broad arena, including biotech approvals and import standards for agriculture products, such as chickens and other meat products. While sanitary and fido sanitary standards are vital to protect our country from foreign pests and diseases, many of our trading partners use these standards as barriers from time to time to stop our exports.

The biotech issue, GMO issue with our European friends is always a continuing issue and I have had significant debates with the Russians over their, I think, faults presentation relative to fido sanitary issues on import of chicken products, for example. We must ensure that our regulatory system produces decisions that are timely and science based and I simply would like a commitment from you to adhere to science-based decisions and not insert political, social or economic considerations into the regulatory process.

Mr. AVALOS. Madam Chair, Senator, that is a good question. I have spent considerable time in my career working in international trade and I know exactly what you are talking about. I remember back in my early career in New Mexico exporting sheep into Mexico I ran into the same situation, so I can understand where you are coming from.

If confirmed as the under secretary, I will work with Secretary Vilsack and this Committee to look at how we can address these issues with our foreign markets.

Senator CHAMBLISS. Will you commit to using science-based technology to implement regulations?

Mr. AVALOS. Senator, absolutely.

Senator CHAMBLISS. Since Senator Thune is not here to ask it, I will ask you about that non-controversial issue of animal I.D. that I think was first initiated before I was elected to the House 15 years ago, 16 years ago.

What are your thoughts relative to the implementation of the animal I.d. program, since it looks like we have finally come to a conclusion of the legislative process?

Mr. AVALOS. Senator Chambliss, I had a hint that question was coming and I appreciate you asking the question because it is of tremendous interest to me and of tremendous interest to the livestock industry in this country.

Animal I.d. is driven really by the need to trace animal disease. I want to applaud Secretary Vilsack for conducting listening sessions all over the country. I think this was critical, extremely important, to allow stakeholders to come in and provide input, provide their concerns, provide solutions.

Coming from New Mexico, we are a brand state and we have probably one of the toughest brand laws in the country. In New Mexico, we have the ability to quickly and efficiently trace a disease outbreak, so in establishing the disease traceability program,

if you will, I feel that brand states—and of course, comment and input from stakeholders should be considered as important.

If confirmed, I would look forward to reviewing the comments from the listening sessions and look forward to working with Secretary Vilsack and the stakeholders to move forward with this issue.

Senator CHAMBLISS. It is a significant concern to all of our livestock producers and the implementation process is not going to be easy, but I am sure you are up to that challenge. As I have said on numerous occasions before, I am quick to criticize USDA when I think they have not acted properly. But often times, we do not compliment them when they do and both Secretary Venneman and Secretary Johanns had a BSE issue to deal with during their tenure as secretary of Agriculture and the department did not get the credit that it really deserves for the way they handled that. It was done quickly, professionally and did not interrupt our markets.

We are still paying a price on some export markets, but it was not due to the fault or the way that USDA handled that. So this ought to give us an additional tool to work with to try to make the current system, which works well, even better. So we look forward to working with you with respect to that.

Mr. Sherman, I have received about 10 letters and e-mails from Georgians about your appointment and they raise concerns about your approach to managing Federal, state and private lands. I am not going to read those this morning. I would simply like a commitment from you to let me get those e-mails and letters to you and have you address those collectively so that I can respond to those constituents of mine who have raised a concern.

As under secretary for Natural Resources and Environment, you are going to have one of the most—you are going to find that most of your time be spent on dealing with U.S. forest issues and I think you have already addressed that. However, there is another very important part of your job and that is to oversee USDA's work with producers conserving private lands.

American taxpayers invest substantial resources in helping producers help the land each year. By and large, USDA does a good job to provide the NRCS—excuse me, to provide the technical and financial support to do that. But the NRCS is under strain and it is under resourced. Farm Service Agency, which is not under your jurisdiction, has exactly the same problem.

We need to find a way to address the infrastructure needs of the agencies that interact with producers on a daily basis. I would like to know what your thoughts are on recruiting, retaining and supporting NRCS' field staff and meeting the agency's technology needs.

Mr. SHERMAN. Thank you, Senator. Let me just say at the outset, I am very, very excited about the mission of NRCS and I am very impressed by the scope of its work. It is truly remarkable all of the areas, the conservation areas, that this agency is now working in. I have been advised that the agency has some 2,500 offices throughout the United States that are on the ground providing services to ranchers, farms and private landowners.

So I am excited by their mission. I think we need to provide them with the resources they need to get the job done properly. I

met with Chief White the other day for the first time and we had an excellent conversation. So we are going to work very, very hard to continue this effort.

There is some wonderful new opportunities out there for NRCS working with ranches and farms. So I simply give you my commitment that I will work very hard at this. I hope we can have an active dialog with each other about this issue and with this Committee and I am anxious to get on with the job if confirmed.

Senator CHAMBLISS. One other issue that you are going to be faced with right out of the box is an issue that while I represent Georgia is of great concern to me, and that is the issue regarding the plight of the farmers out in San Joaquin Valley in California. It is an issue that certainly involves ESA, which means Secretary Salazar and the Department of Interior may have some primary jurisdiction over part of it. But it does involve farmers in that part of the country.

They have a real significant issue that they have to deal with and I would simply ask that when this does hit your desk, and it will be there the day you are sworn in, that you give immediate attention to that and work very closely with the Department of Interior to let us see if we cannot provide some assistance to those farmers out there who truly are suffering. When you look at the percentage of produce that is delivered to our farmers markets and grocery stores around the country that come from the San Joaquin Valley, it is significant, which means that U.S. agriculture is suffering as a result of that issue.

Mr. SHERMAN. I know Senator Salazar, Secretary Salazar very well and I will look forward to talking to him about that issue.

Senator CHAMBLISS. Mr. Spearman, your nomination to this position at Farm Credit is coming at a critical time in the financial community that both Farm Credit, as well as other financial institutions around the country, deal with. Agriculture, the challenge by the turmoil in the economy, has weathered the storm fairly well.

With your experience with an agriculture cooperative, you have seen ups and downs in agriculture firsthand. How would you compare last year's troubles to past experience? What challenges and opportunities do you see ahead for agriculture and what role do you see the Farm Credit System play in providing financing to producers as they face those current challenges and opportunities?

Mr. SPEARMAN. Thank you for that question, Senator Chambliss. Of course I was not around and working with cooperatives during the eighties, but I have heard a lot of conversation there about the troubles with land prices that the farmers had and the drying up of credit for a lot of those folks who ended up losing their farms and losing their properties.

I think the controls that were put in at that time—the Federal Government did step in and briefly help the Farm Credit System, by which the Farm Credit System has paid all of that money back. I do think that the GSE designation for the Farm Credit System has worked adequately. I think that there is stresses in the industry currently, particularly in the dairy and in the poultry and in some of the livestock industries.

I think the system has procedures and practices in place that is effectively dealing with the problem. Agriculture tends to lag the

commercial industry. I believe that there is adequate capital out there for sound loans to be made and I just think that the industry and the system is postured to continue to have credit for the ranchers and farmers into the future.

Senator CHAMBLISS. Thank you very much, Madam Chairman.

Chairman LINCOLN. Thank you, Senator Chambliss. Just to touch real quickly and there may be others in the Committee that would like to submit questions for the record, so just to give you all a heads up on that and I may actually join them with a couple.

But Mr. Avalos, Senator Chambliss brought up the biotechnology and the importance of implementing a timely and science-based approval process and working through some of those things. I just would stress the timeliness on that. My understanding, that currently the average length of time for agency decisions, making petitions for regulatory approval of agricultural biotech products, has steadily increased and it is alarming to me, I do not know if you mentioned those numbers, but from approximately 150 days in 1996 to almost 700 days at present.

Our hope is, I do not know if you are aware of that big of an increase in terms of delay, but hopefully there will be plans to reduce the current lengthy petition process as it exists. We are going to need to be more competitive than ever in this growing—as we rebuild our economy and the global economy and I think that efficiency is going to be a critical part of how we do that.

So would just like to bring that to your attention and hopefully you can play a role in improving upon that.

Mr. AVALOS. Thank you, Madam Chair. I acknowledge your concerns and if confirmed, I definitely will follow up on this.

Chairman LINCOLN. Well 700 days is an awful long time to go through a process. I do have a few other questions, actually one more just to bring to your attention, Mr. Avalos. There has been a recent, from the USDA, the Animal Plant and Health Inspection Service, APHIS, they are delaying right now for 30 days the implementation of a recently increased—announcement of an increase in fees charged for certain agricultural quarantine and inspection services.

I would like to visit with you more on that hopefully in the future. I think the 30 days may be adequate, but I am not sure that it is going to be adequate in order to make sure that all of those that are participating, whether it is passengers or airlines or others, are going to be able to put that into place as quickly as that may be. So as much as we do not want to delay, we also want to make sure there is adequate time to implement, and so we may be following up with you on that at a later date.

The Committee has also received various letters of support for one or more of our nominees here today and Senator Chambliss, if there is no objection, I would like to make those letters a part of our record. So without objection, that would be so ordered.

[The information referred to can be found on page 216-224 in the appendix.]

Chairman LINCOLN. If there is no other matters that we need to discuss, I have one last housekeeping item. Senators do have until close of business tomorrow to submit any further questions and the record will remain open for five business days in order to give you,

the nominees, the sufficient time you need to respond and we hope that you will be respectful of that as we try to move forward on your nominations. We do need the response to those questions in a timely way.

I want to thank all of you all for appearing before us today and your willingness to serve our government in these capacities. I would also like to take this opportunity to say that we are only as strong as the team that we play on and the Agriculture Committee staff is a phenomenal team. Both the Majority staff and the Minority staff do a tremendous job and I want to personally thank them for helping to make my first hearing a success, in my estimates, and I hope in others'. But they work tirelessly and do a tremendous job on behalf of the Committee.

As I said, it may not be the most glamorous of committees, but it is one that has an unbelievable diversity in terms of the breadth of issues that it covers and the expertise within the staff on the Majority and Minority side are a tremendous asset to the country and I am grateful to all of them for the hard work that they do.

I am still holding out on you, Vernie, but appreciate all of you all for a very historic day for me and one that is very meaningful and I thank you all for participating in it. We appreciate you in offering yourself for service. And a special thanks to my colleague and friend, Senator Chambliss.

With that, the Committee is adjourned.

[Whereupon, at 12:06 p.m., the Committee was adjourned.]

A P P E N D I X

SEPTEMBER 30, 2009

Statement of Senator Thad Cochran

Committee on Agriculture, Nutrition, and Forestry

September 30, 2009

Madame Chairman, I congratulate you on ascending to the chairmanship of this important Committee. Your successful work on behalf of farmers and ranchers is well known and appreciated. I look forward to working with you to review and improve the programs under the jurisdiction of this Committee.

I am pleased to introduce to the Committee Mr. Scott O'Malia who has been nominated by the President to serve as a Commissioner of the Commodity Futures Trading Commission. I have known Scott and worked with him for a number of years, and I believe he is very well qualified for this important position.

Since 2004, Scott has served as a staff member of the Senate Appropriations Committee. Currently, he is the Minority Clerk of the Subcommittee on Energy and Water Development. As Clerk, Scott leads the effort to develop the annual appropriations bills for the Department of Energy, the U.S. Army Corps of Engineers, and the Bureau of Reclamation.

Prior to joining the staff of the Appropriations Committee, Scott served as Professional Staff on the Senate Energy and Natural Resources Committee. His responsibilities included oversight of both energy trading markets and oil and gas production. His previous experience will give him valuable insight into the work of the Commission and other regulatory agencies.

Scott has also gained valuable private sector experience related to corporate risk management. From 2001 – 2003, he worked to establish rules and standards for energy trading among various wholesale power producers.

His experience with energy related policies and activities will provide the CFTC with valuable insight when reviewing energy related financial instruments and regulatory proposals. Scott's knowledge of the Senate and its responsibilities will prove helpful also as we work to exercise oversight of government agencies under the Committee's jurisdiction.

I enthusiastically support the nomination of Scott O'Malia to serve as a Commissioner of the Commodity Futures Trading Commission.

Statement by Senator Pat Roberts
Nomination Hearing
Senate Agriculture, Nutrition, and Forestry Committee
September 28, 2009

Madam Chairman, I want to convey my strong support for the nomination of Jill Sommers to a second term on the Commodity Futures Trading Commission.

Jill is a native Kansan and a graduate of the University of Kansas. She's actually from the picturesque town of Fort Scott, home to the Ft. Scott National Historic Site and National Cemetery.

She is well qualified for this position. Having served on the staff of Senator Bob Dole and worked in several positions in the futures industry, she has the background and understanding necessary to address the difficult issues she will face as a CFTC Commissioner.

More importantly, being from Kansas she understands agriculture and the significant role the CFTC plays in regulating our agriculture markets.

Madam Chairman, the CFTC faces several challenges in bringing additional transparency and accountability to the marketplace while at the same time providing opportunities for producers to better manage their risks.

Thankfully we have high caliber folks like Jill and others who are more than up to the task.

I am proud to support Jill's nomination as a fellow Kansan.

TESTIMONY OF EDWARD M. AVALOS
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman Lincoln, Ranking Member Chambliss, and Members of the Senate Committee on Agriculture, Nutrition, and Forestry, thank you for the opportunity to appear before you today. Also, I would like to thank Senator Bingaman for his kind words and for his efforts in representing the State of

New Mexico. Also, I am extremely grateful to President Obama for nominating me and Secretary Vilsack for his support. With me today is my better half Anna Bee from Mesilla, NM, my daughter Alexandra and her fiancé Tom from Long Beach, California; my daughter Megan and her fiancé Mark, from Phoenix, Arizona; and my son and fishing and hunting buddy, Russell from Las Cruces, New Mexico.

Madam Chair, Members of the Committee, it is an honor to be nominated to serve as the Undersecretary for Marketing and Regulatory Programs at the United States Department of Agriculture (USDA). The mission areas include the Agricultural Marketing Service (AMS), Animal and Plant Health Inspection Service (APHIS) and Grain Inspection Packers and Stockyards Administration (GIPSA). Each of these agencies is extremely important and contributes to benefit the agricultural industry all the way from the producer, through the shipper, processor, retailer, and on to the consumer.

I grew up on a family farm in the Mesilla Valley of Southern New Mexico. At an early age, my parents, Adolfo and Eva Avalos, instilled a strong work ethic which I have followed throughout my professional life. My 30-plus years of experience in agricultural marketing have prepared me for my role as the Undersecretary. I have worked with the agriculture industry to address regulatory, marketing, production, and other issues and challenges in both the national and international arenas. I am a firm believer that the United States (U.S.) agricultural sector has been and continues to be the backbone of this country providing food and fiber to consumers and end users in the U.S. and also to markets all over the world.

During my career, I gained considerable experience in both the international and domestic arena. I have worked to support the production and marketing of livestock, specialty crops, and value-added products through the implementation of trade missions, dialog, and trade promotion.

Also, I've worked with diverse stakeholders to develop, establish and maintain markets for sheep, cattle, goats, and numerous fruits and vegetables in Mexico; onions and processed foods to Canada; and most recently, the pecan grower's success in creating an export market in China.

In the domestic arena, I have been successful in establishing markets for chile, onions, potatoes, watermelons, pumpkins, pecans, beans, and alfalfa. I have worked closely with producers to support the production of crops that the industry demands, with distributors for timely delivery of goods and with retailers to showcase, promote, sell, educate, and inform the consumer

utilizing brochures, recipes, and other promotional and educational tools.

In addition, I have worked to advance Indian agriculture, including working closely with the Navajo Agricultural Products Industry—an 85,000 acre farming enterprise located on the Navajo Nation in the four corners area of New Mexico and with some of the pueblos in Northern New Mexico to bring back traditional agriculture to their tribes.

I believe it is important to create an atmosphere of collaboration and foster good communication throughout agriculture production. I am enthusiastic about opportunities to promote fresh and local availability of products, more farmers markets, and better connecting the American public with their food supply.

As a result, I have established an effective and informative network of growers, shippers, trade organizations, and other stakeholders throughout the country. I've worked closely with the North American Agricultural Marketing Officials, National Association of State Departments of Agriculture, and the Western United States Agricultural Trade Association. This network provides much needed input on issues and trends within the food, agricultural, and livestock industries.

If confirmed as undersecretary for Marketing and Regulatory Programs, I will emphasize providing oversight for the three agencies and addressing the concerns of agriculture boards and commissions. If confirmed, I look forward with enthusiasm to stimulating employee morale and working with the many fine public servants assigned to my area as well as with the other agencies at USDA. I am strongly committed to Civil Rights at the Department and will work hard to ensure USDA's employment practices will not tolerate any form of discrimination, but instead will create a positive environment that celebrates and draws upon the strength of USDA's diverse workforce and customer base.

If confirmed, I am committed and dedicated to working with Secretary Vilsack and this Committee to address and resolve the many concerns and difficult issues facing the food, agriculture, and livestock sectors in this country. Building on my experience with farmers, ranchers, dairymen, shippers, brokers, processors, distributors, retailers, and consumers, I will provide the leadership and guidance needed to implement the farm bill and carry out our mission at USDA.

Thank you for your consideration and I look forward to responding to your questions.

Testimony of Commissioner Bart Chilton
Commodity Futures Trading Commission
Before the
United States Senate Committee on Agriculture, Nutrition, and Forestry
September 30, 2009

Madame Chair, Senator Chambliss and members of the Committee, thank you for the opportunity to be before you, yet again. It's a particular honor to be here today as one of the first witnesses, at the first hearing to be gavelled by the hand of the first woman chair of this Committee in its illustrious 184-year history. There have been 48 chairmen of the Committee since 1825, and some great ones at that—including some Senators who still serve. However, there has never been a woman or an Arkansan as Chair, and I feel very privileged to be here at this moment in history.

I have testified before the Committee each of the last two years. Last year, I gave what I called a "report" on my first year at the CFTC. I'd like to do that now, and like last year, I'll be brief.

The futures industry was not at ground zero of the "recession"—that is, the credit crisis and the recession. The Commodity Exchange Act (CEA) and the amendments thereto have worked fairly well—as have these markets for most of their more than 150-year history. That said, this is not only an opportune time to look at what we can and should do better, but it is also a propitious time to review how we are moving forward to continue to ensure that these markets are efficient and effective and that we do all we can to avoid fraud, abuse and manipulation.

New Speculators

First, there is still debate about what impact new speculative activity has had in these markets, particularly as we saw a commodity bubble last year. Some say a lot, some say none, some say a little. Here is what I know: approximately \$200 billion went into these markets in the last few years from a new asset class of non-traditional investors. Many of them are what I've called the "new speculators," that is, pension funds, university endowments, state and local governments and index traders who generally take and hold long positions indefinitely. These new speculators are a different phenomenon in the futures markets, which have traditionally been populated by commercial traders—those with a business interest in the underlying physical commodity—and traditional speculators—those who go in and out of the markets, providing liquidity for hedgers, based on their judgments of price movements. The new speculators have a different *modus operandi*. They get in the markets, by and large, and stay there—most of the time regardless of price. They are passive long traders who are betting that the price of a commodity will be worth more in a time certain—say five years—than it is today. They don't alter their trading strategy on daily prices or other information coming into the markets—this is

sometimes referred to as being “price insensitive.” As regulators, we need to be aware of the potential effects and activities of these new participants in the markets, and what their impact may be on traditional market users and the primary functions of the futures markets, that is, price discovery and risk management.

My take on this is that the new speculators have had an impact. That impact was likely divorced from the fundamentals of supply and demand, and has effected farmers putting seed in the ground, consumers and businesses putting gas in their cars and trucks, and families putting food on their tables. I’m not suggesting that the new speculators are necessarily the primary “drivers” of commodity prices, but I think they have had an impact. So, what do we do, as regulators, with that?

Under the Commodity Exchange Act (CEA) Section 3, a fundamental mission of the CFTC is to guard against fraud, abuse and manipulation. That means taking some precautions. In my mind, we need to do this in a way that doesn’t roil markets and that doesn’t send trading to less regulated venues or to overseas trading platforms.

Position Limits/Hedge Exemptions

Given the amount of volatility we’ve seen over the last two years in commodity prices, it makes sense for us to review limits on the amount of positions that traders can hold and also to look at exemptions to those limits. We have had position limits in the agriculture commodities since the 1940s, and they seem to have worked pretty well (although we have certainly seen some significant hiccups in the last two years). I don’t know why appropriate position limits wouldn’t make sense in the other physical commodity markets, specifically, energy and metals. That’s one of the benefits of principles-based regulation: it allows us to innovate, bring something new and needed to markets as we see it’s required. We certainly need to strike the right balance, but since our obligation under the law is to guard against, among other things, manipulation, this seems like an appropriate course to pursue.

The Commission is currently considering what appropriate action(s) we can take in this regard and I commend CFTC Chairman Gensler for holding a series of hearings this summer on these specific topics.

Whatever we do, or don’t do for that matter, we need to account for the markets we don’t observe. The CFTC does not have a full-landscape view of the derivatives markets and as a result, we cannot protect consumers as we should. The over-the-counter (OTC) markets are comprised of billions upon billions of dollars of unregulated trading. This is where credit default swaps began trading, metastasized among traders, and then played such a significant part in the recession. All of these trades were done out of the view of regulators. I do care about larger OTC trading that could have an impact upon the currently regulated exchanges, or upon price. I care about OTC look-alike contracts traded on exempt platforms—just as I care about look-alike contracts on Foreign Boards of Trade (FBOTs). I don’t know that as a regulator, however, just how much I should care about insignificant bilateral trades between say, a grain elevator and a large producer, if that transaction doesn’t affect commodity prices or extend beyond local commerce. But as I say, I’d like more of a panoptic view of all markets, and that means looking

at OTC trades in some significant fashion. It also means having regulatory and enforcement authority over these currently unregulated markets.

The Commission is currently considering what we can do, in appropriate fashion through our rulemaking, on position limits and hedge exemption. Whatever we do, assuming we do anything, we need to do that with an eye toward the OTC markets. Some have suggested that if we impose position limits on the regulated exchanges that the trading will simply move to the OTC markets or overseas. That is a good point, and whatever we do needs to be done in light of what the Congress may do with regard to OTC trading as part of a regulatory reform measure. While I do not think that the CFTC must wait on Congress to act on regulatory reform, I do believe we need to be cognizant of the entire environment in which we are operating and ensure that whatever we do doesn't have a perverse impact on markets, traders, or most importantly, upon consumers.

Manipulation

The issues I've addressed have been the subject of many hearings and written about in the news media, but they are important so I wanted to mention them once again. There are, however, three other issues I wanted to raise that have not received as much attention.

First, I think Congress—and specifically this Committee—should seriously consider changing our manipulation standard. It's an opportune time to address this, inasmuch as you have the issue of financial regulatory reform on your agenda. Just a few weeks ago, we had two days of hearings with the Securities and Exchange Commissioner (SEC). These were historic in that the Commissioners of the two agencies had never met in a public setting before. They were long overdue given the myriad issues of mutual interest between the two agencies. One issue that I highlighted (and our Chairman also raised questions on this point), is the varying manipulation standards. If you compare the agencies' manipulation standards, the SEC has an easier legal hurdle to jump, and I think this may be a great opportunity to adjust our standard to be more in line with theirs, particularly in light of the Administration's call that our agencies harmonize our rules and regulations. The Federal Energy Regulatory Commission (FERC) and the Federal Trade Commission (FTC) have standards similar to the SEC's manipulation standard.

To be more specific, under applicable case law the CFTC is required to prove "specific intent" to manipulate. That is a very difficult standard to reach, not to mention that it leaves a lot of wiggle room for mischief that is clearly prohibited by the Act, yet not categorically outlawed. It would be extraordinarily unlikely that any individual, for example, would explicitly write in an e-mail that he or she specifically intends to manipulate prices. But that's what our law currently requires. In fact, this standard is so high that in the CFTC's 35-year history, while we have settled numerous manipulation cases, we have only successfully prosecuted and won one single case of manipulation in the futures markets! Only one. And that case, the DiPlacido matter, is currently on appeal in federal court.

In addition, our case law requires that we prove an artificial price exists, that the defendant had market power to move the price, and that he or she actually did cause the artificial

price. Particularly in today's complex markets, proving "artificial price" can be a daunting task, which more often than not comes down to a "battle of the experts" in court. Because these requirements are so onerous, we often end up moving to a lesser charge of "attempted manipulation," which requires only proving intent and some act showing that intent. This is still a high standard, but is much easier than proving up a full manipulation case. Again, we've been very successful over the years, particularly in the energy arena, in obtaining significant settlements in attempted manipulation cases, but we've not had success in litigated cases because of our very difficult manipulation standard.

The Securities and Exchange Commission (SEC), on the other hand, under its "10b-5 rule" has a different, easier-to-prove manipulation standard. Basically, they are not required to prove specific intent, as we are, they just must prove that the defendant acted "recklessly." I'm not saying that the answer is wholesale adoption of the SEC manipulation standard, but clearly, as Senator Cantwell and others have recently noted, we need to do something different at the CFTC. The status quo simply isn't good enough.

A recent federal court case in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of \$303 million—the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that case by bringing a criminal case against four of the participants in the scheme. Two weeks ago, the Texas judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met. Clearly, the current standard is not working.

I would point out that, in looking at other jurisdictions around the world, virtually all nations have rules prohibiting this type of conduct, and it is a criminal offense in many of those jurisdictions, entailing significant sanctions. In this country, our current standard in the futures arena is ineffectual. It is not sufficient to fully prosecute and deter abuses in the markets, and I'm hopeful that in working with Congress, we can all move forward on figuring this out.

Criminal Authority

Another issue that I think deserves more attention—related to our manipulation standard and enforcement efforts—is criminal authority. Neither the CFTC nor the SEC, the two principal federal financial regulators responsible for policing the exchange trading markets in the United States, has legal authority to put bad guys in jail. Both have authority to bring cases in federal court against fraudsters and scam artists, but the only penalties in their regulatory arsenals are civil—monetary fines, for example. The Federal responsibility for putting people behind bars is reserved, currently, for DOJ. And the reality, unfortunately, is this: it is becoming tougher and tougher to incarcerate felons because of a lack of legal authority—criminal authority—for financial regulators.

Violations of commodities and securities laws often involve highly technical and complicated trading schemes. To prosecute these violations effectively, attorneys and investigators must be experts in the complex functioning of these markets. SEC and CFTC

enforcement personnel are specially trained to handle these matters, unlike DOJ prosecutors who are more likely to be unfamiliar with the mechanics of financial trading and the interstices of federal financial laws and regulations. That doesn't mean that there aren't very qualified DOJ attorneys who understand futures law. There are some, but not enough. While DOJ attorneys do an excellent job in their prosecutorial functions, it is simply asking too much to expect them to be expert in the types of complexities that commodities and securities professionals deal with on a daily basis. It is perhaps understandable why it is difficult to get them to commit scarce resources to prosecute complicated financial fraud and manipulation cases.

Since 2002, the CFTC has referred over 100 cases to DOJ and other criminal authorities (such as state and local law enforcement bodies). Unfortunately, two-thirds of those criminal referrals have been rejected. One might think that we aren't sending them good criminal cases, but that's not the situation. In fact, in 100 percent of those matters, the CFTC moves forward and we reach a favorable outcome for the government.

The bottom line is that folks who do the crime often only pay the fine and don't do the time. Other financial regulators around the world—in the United Kingdom, Australia, Hong Kong, and Japan, for example—already have such criminal authorities. Chairman Peterson of the House Agriculture Committee has taken a leadership role on this issue, resulting in passage by his Committee of a provision that would grant the CFTC such authority. I understand that this raises jurisdictional issues—both in Congress and with DOJ. Perhaps there are good reasons that this should not be done. So far, I haven't heard those reasons. I have heard that, "It has never been done." I have also heard that, "Only DOJ should handle such cases since they are the Executive Branch." But, what are we? The CFTC is part of the Executive Branch. Granted we are an independent agency, and perhaps that raises issues that cause some concern. Again, however, I haven't heard a good argument against this proposal. Certainly, I'm hopeful that congress will consider this change.

Consumers

Finally, I think the Commission needs to revitalize its commitment to educating, protecting and advocating for the investing public. The futures markets of today are not the same as they were even three years ago, and that is, in part, due to new participants. With the advent of new and novel products, and the recession, the investing public are now moving their assets into the futures markets with exponential momentum, and they are sometimes doing so without full and complete understanding of the nature of the investments or strategies.

The CEA specifically empowers the CFTC to engage in education and outreach efforts to protect market participants from fraudulent and other abusive sales practices, and I am committed to a renewed effort to provide consumers with information they need and want regarding financial investing. We need to become a more user-friendly public resource for investors and prospective investors. Only through increased financial literacy will the investing public be better able to navigate the investment choices currently before them. I'm committed to providing this resource to American consumers to provide the protections and information they need and deserve.

Thank you for the opportunity to be with you today. I'd be pleased to answer any questions at the appropriate point.

STATEMENT OF SCOTT D. O'MALIA
Before the
United States Senate Committee on Agriculture, Nutrition and Forestry
September 30th, 2009

Madame Chairman, Ranking Member Chambliss and members of the Committee thank you for the opportunity to testify today. Madame Chairman, I would like to congratulate you on becoming Chairman of this Committee.

I am grateful to appear before you as President Obama's nominee to serve as a Commissioner to the Commodity Futures Trading Commission (CFTC). I would like to thank Senator Bennett for his support and willingness to introduce me to the Committee. As a Michigan native, I would also like to thank Senator Stabenow for her support as well.

Before, I begin I would like to introduce my family. I am joined by my wife, Marissa and three daughters Kelsey, Claire and Macey. I would also like thank my parents, John and Bev O'Malia, for joining me here today. I would not have this opportunity today if it were not for the support of my wonderful family.

I am honored to be nominated by the President to serve as a Commissioner to the Commodity Futures Trading Commission. Given the fact that this country has experienced the worst financial meltdown since the great depression, I recognize the enormous responsibility of this office.

Like everyone in this nation, I too have lost value in my home, retirement and college savings. I am sensitized to the hardship this crisis has caused families across the country. This experience reinforces my strong belief that our nation's financial regulators must be vigilant in their oversight responsibilities to ensure transparency and accountability in our markets. Furthermore, regulators must recognize the inherent risk associated with the trading products which have contributed to this crisis and they must commit to doing all they can to maintain stability and security of our financial markets.

I believe the oversight of our financial institutions and markets must be strengthened. I am committed to exposing the underlying risk and trading practices that might further destabilize our economy with serious impacts on our financial, energy and agriculture markets. The stability of our futures and commodities markets require that trading occur among reliable parties with as much information as possible. I am also concerned that extensive leverage and uncertain collateral values could destabilize these markets.

Madam Chairman, for the past six years, I have worked in the Senate serving on the Senate Energy and Natural Resources Committee and the Senate Appropriations Committee. During this time, I have focused my work on energy policy with the goal of reducing our nation's dependence on foreign energy resources and expanding U.S. investment in clean energy technologies, including improving the effectiveness of the Department of Energy's Loan Guarantee program.

Over the past three years, the Energy and Water Subcommittee has authorized and appropriated over \$50 billion worth of self-financed loan guarantees and invested tens of billions of dollars into research and development to support the deployment of clean energy technology.

Transformation of our energy sector requires more than federal research assistance. It requires billions of dollars in new investments that will occur only if investors believe energy markets are stable, provide reliable price transparency and offer the opportunity to hedge their commercial risk.

Prior to joining the Senate Energy Committee, I spent two years in the electricity sector. This experience provided an invaluable education regarding the devastating impacts a flawed market design and illegal trading behavior can have on consumers. As a result of this experience, I am resolved to prevent this catastrophe from being repeated.

I joined Mirant in February 2001, as a director of federal affairs focused on federal energy policy. I did not work for a trading desk or for a business unit that managed generation assets. By the time I arrived, it was already apparent the California electricity market was dysfunctional. California had experienced a difficult summer with record energy prices and blackouts in June, 2000. By November 2000, FERC had determined that the California market was flawed, making it possible for manipulative trading behavior to cause an imbalance in supply and demand that made electricity rates unjust and unreasonable.

In response to the trading behavior uncovered in 2001, I worked with Mirant's Chief Risk Officer and five other energy companies to establish the Committee of Chief Risk Officers (CCRO). This organization was created to prevent and avoid the trading abuses used by some in the industry to manipulate the California and Western energy markets.

The CCRO established industry wide trading protocols, improved price disclosure, required clearing and standardized contracts and imposed a corporate trading code of conduct. These standards would give regulators, consumers and investors a better view into the business and operations of these companies.

I do recognize that many of the same reforms implemented by the Committee of Chief Risk Officers are now embodied in the financial overhaul proposed by the Administration, but on a larger scale. Both efforts seek to improve transparency of Over-the-Counter markets, reduce systemic risk and set trading standards to reduce opportunities for excessive speculation and manipulation. A key component of both efforts has been the utilization of clearing to reduce counterparty risk and allocate capital more efficiently.

My experience reaffirms my strong belief that regulators are critical in ensuring that markets operate in a fair and transparent manner. To achieve this, regulators must be provided with the appropriate authority and tools to respond to the constant evolution of market behavior and products.

As I stated in the beginning, I am sensitive to the impacts the financial crisis has had on families across the country. I also understand the consequences to all of us if markets, which are designed to offer protection from risk, are manipulated and thereby expose our financial system to greater peril.

Drawing on my extensive energy background, I believe I can make a significant contribution to the Commission. If confirmed, I will work with the other Commissioners to ensure markets continue to offer consumers and producers the opportunity to cost-effectively hedge their commercial risk and facilitate the dissemination of timely and accurate market price data. I will work to ensure the CFTC uses all of its legal authorities to curb excessive speculation and prevent abusive trading practices, including fraud and manipulation.

I would like to thank the Committee for holding this hearing and considering my nomination. It would be an honor and a privilege for me to serve as a Commissioner to the CFTC.

Madam Chairman, I would be pleased to answer any questions.

Thank you.

Opening Statement for Harris Sherman, Nominee for Undersecretary for Natural Resources and the Environment, United States Department of Agriculture

Thank you Madame Chairman. It is a great honor to appear before this Committee regarding my nomination for the position of Undersecretary for Natural Resources and the Environment at USDA.

And Madame Chairman, it is also a great honor to be present today at this historic proceeding where you assume the Chairmanship of this crucial Committee. If confirmed, I very much look forward to working with you in your new capacity and with all the members of this Committee.

Several weeks ago when I received the news that President Obama had nominated me for this position, I was deeply humbled by the honor but also by the degree of responsibility that accompanies the position. I fully realize that the challenges ahead will not be easy but it is an extraordinary opportunity to do good things for our country. If confirmed, I promise to use my strengths, energy, commitment, and good judgment to advance the conservation and public land programs that will fall under my jurisdiction. And I promise to work closely with you and the other committees of Congress as we go forward.

My interest in overseeing the Forest Service and NRCS stems from a lifetime of experiences with public lands and conservation programs. As a child, my parents took me to the mountains outside Denver where we would camp, hike, fish, ski, and jeep. These experiences left an indelible impression on me about the grandeur and importance of our national forests. Later, I twice have had the privilege of serving as Colorado's Director of Natural Resources for two different governors where I have worked on a daily basis with the Forest Service and other federal agencies on complex, challenging resource issues. And between these two stints as DNR director I have represented as an attorney both public and private sector clients in their dealings with federal land management agencies. These experiences, combined with my earlier work with the State Soil Conservation Service and my later work with many land trust conservation organizations, have given me a background that I believe will serve me well in meeting the Forest Service's mission.

Looking forward, there are tremendous challenges regarding our forests, both federal and private, and the conservation programs associated with farms and ranches throughout the country. On the forestry side, many forests are in trouble due to past fire suppression, increasing fuel loads and changes to our climate. As a result, many forests are far more vulnerable to catastrophic fire, disease and invasive species, often in epidemic proportions. We are witnessing far more frequent, intense fires than we have seen in the past. Combining these factors with a growing human population influx within or adjacent to our public and private

forests, it is clear that we have a very challenging situation ahead. How we protect our growing communities from fire danger; protect the watersheds within our forests that supply drinking water to much of our population; protect wildlife species that rely centrally on these forests; and insure that our forests play a critical role as carbon sinks is a herculean responsibility. I believe that Secretary Vilsack's emphasis on restoration of our forests, both federal and non-federal, in a manner that addresses climate change, environmental protection, identifies new markets for wood products, creates jobs, and sustains rural communities provides an excellent framework for moving forward.

It is also important that we take a holistic approach to land conservation issues and fully integrate our approach to both public and private working lands. On the NRCS side of the ledger, I have much to learn but I am excited by the mission and scope of the Agency's charge. Conservation on private working lands plays a significant role in protecting water resources and wildlife habitat, creating jobs through market-based conservation opportunities and providing economic opportunities for rural America. NRCS's watershed protection programs help protect communities from floods – like those we just saw in Georgia. With its comprehensive programs, on-the-ground expertise and powerful technical tools, NRCS is well positioned to help private landowners play a significant role in addressing a variety of the nation's conservation challenges.

Together the Forest Service and NRCS can make a major difference. Never before have agriculture and forestry been more at the forefront of current national policy issues. This is an urgent time to make progress. I am excited by the prospect of devoting my energies to these tasks. I promise you that, if confirmed, I will undertake collaborative efforts involving appropriate stakeholders to find common sense solutions and to come up with answers that will withstand the test of time, becoming durable, longstanding, reliable programs.

Thank you.

**Statement of Commissioner Jill E. Sommers
Before the United States Senate
Committee on Agriculture, Nutrition and Forestry
September 30, 2009**

Chairman Lincoln, Ranking Member Chambliss and other members of the Agriculture Committee, I am honored to be nominated by President Obama for another term as a Commissioner at the Commodity Futures Trading Commission (CFTC). I have been in this position since August of 2007, and it has been a true privilege to serve the American public as a regulator of the U.S. commodity futures and options markets.

During my career, I have had the opportunity to work on Capitol Hill for Senator Bob Dole, for a regulated derivatives exchange, as well as for the trade association representing participants in the privately negotiated derivatives industry. I believe this unique experience gives me a diverse view of risk management issues and the knowledge to help implement our core mission at the CFTC.

Since 1974, that mission has been to protect market users and the public from fraud, manipulation, and abusive trading practices related to the sale of physical and financial futures and options, and to foster open, competitive, and financially sound markets. The agency endeavors to ensure the fairness, efficiency, and economic utility of the markets through a strong regulatory oversight program that includes market surveillance to detect and prevent manipulation and other market disruptions as well as ensuring the financial integrity of the clearing process. This risk-tailored approach to regulation is also complemented by strong enforcement as evidenced by over \$2.8 billion worth of penalties and restitution assessed in actions brought by the CFTC since the year 2002.

Through effective oversight, we facilitate the important hedging and price discovery functions that the futures markets were designed to serve. This regulatory regime has enabled the futures industry to experience enormous growth over the past decade. In FY 2000, the U.S. exchange traded volume was 580 million contracts. In FY 2009, the volume is 2.8 billion contracts, which is a 383% increase. Even with that growth, the regulated futures industry did not endure the loss of any customer funds during the current economic turmoil due to the default or failure of a futures commission merchant (FCM).

Although the regulated futures exchanges and FCMs have performed well throughout the financial crisis, there is a widespread belief that the CFTC's regulatory authority should be extended to cover the trading of over-the-counter (OTC) derivatives. There is broad consensus that more transparency must be brought to these markets. The current Commission is unified in support of comprehensive regulatory reforms including full regulation of the over-the-counter markets (OTC). This regulatory framework would cover both OTC derivative dealers and the OTC derivative markets in which they trade.

I believe we need to enhance transparency and close regulatory gaps to achieve improvements in the regulatory structure. To that end, the CFTC has undertaken a number of initiatives over the past year to strengthen our regulatory oversight and

thereby enhance public confidence in the markets we regulate. There is no doubt that public confidence in the markets is crucial. Unless the public is assured that the markets are operating efficiently and are free from abuse, commercial producers and users of the commodities underlying futures transactions will be reluctant to use the markets to hedge their price risks, and the information they would otherwise bring to the markets—which is essential to discovering accurate prices—will be lost. We must strive to bolster that confidence and strengthen market integrity. As decision makers, it is our job to implement prudent government solutions. The CFTC has a responsibility to achieve these objectives, and if reconfirmed, I look forward to continuing to ensure this responsibility is met.

Under the leadership of Chairman Gary Gensler we have taken several steps recently to fulfill those objectives. First, the Commission held three days of hearings in July and August to review the application of and exemptions from position limits for futures contracts involving physical commodities, with a particular focus on energy commodities. We heard from almost thirty witnesses with very diverse points of view. Second, together with the Securities and Exchange Commission, the CFTC held two days of joint public meetings the first week of September to discuss issues of regulation harmonization. The two agencies have been asked by the Administration to identify conflicts in how we regulate similar financial products and to either explain why those differences further important policy goals, or make recommendations for resolving differences where they do not. And finally, on September 4, we implemented two new transparency measures by further disaggregating our Commitments of Traders (COT) report and publishing an updated report, Index Investment Data, based on the information we have been receiving since June of 2008 through our special call authority.

The questions surrounding these issues are enormously complex and require thoughtful resolutions. Our staff is working very hard to provide recommendations on these as well as a number of other important initiatives. I want to take this opportunity to salute the dedicated men and women at the CFTC who serve the American public and the futures industry with great distinction. I am very proud of their work and know they will do an outstanding job implementing any recommendations for enhancing and harmonizing the regulatory framework.

Not since the Commodity Exchange Act and the securities laws were passed in the 1930s has there been a time when events have coalesced, as they have over the past year, to bring into such sharp focus the need for harmonizing regulation and closing regulatory gaps. As a commissioner at the CFTC, I believe there is a historic opportunity to reshape the regulatory oversight of financial markets. It is a very challenging time for the Commission and I am committed to strengthening regulation where needed and eliminating inefficiencies where possible. If confirmed by this Committee and the United States Senate, I will work hard to ensure that the CFTC continues its role of protecting the integrity of the markets while addressing concerns about the regulatory structure. It is the responsibility of the Commodity Futures Trading Commission to defend the crucial risk management and price discovery functions provided by our commodity futures and options markets.

**Testimony of
Kenneth A. Spearman
Before the
Senate Committee on Agriculture, Nutrition, and Forestry
September 30, 2009**

Thank you, Chairman Lincoln, Ranking Member Chambliss, and the distinguished members of the committee. Senator Lincoln, congratulations on assuming the Chairmanship of the Committee. I look forward to your leadership and to working with you, Senator Chambliss, and this committee for the betterment of American agriculture.

I also want to thank Senator Nelson for his kind and generous introduction. He serves my home state of Florida in the United States Senate with honor and distinction. If confirmed, I will keep the trust of his example of public service to our Country.

It is a privilege to appear before you today as President Obama's choice to serve as Board Member of the Farm Credit Administration. This is a special day for me and I am honored that my family is here to share it with me. We all achieve success in life with the help of others. I'm no exception, so I especially want to acknowledge my wife, Maria, my twin daughters, Michelle Springs and Rochelle Puccia, and my son, Dr. Kenneth Spearman.

It is indeed an honor to be nominated to this prestigious position. I would like to share my background and tell you about the skills and experience I would bring to the Farm Credit Administration Board, should the committee confirm my nomination.

As an accountant, I was involved with the development of a public accounting firm in Chicago, Illinois, and later worked as an accountant for a major accounting firm. From 1980 to 1991, I served as Controller of Citrus Central, Inc., where I was responsible for financial management and reporting for this \$100 million agricultural cooperative. Until recently, I was the Director of Internal

Audit for Florida's Natural Growers, Inc. There I was responsible for the design and implementation of the annual plan, which was used to appraise the soundness, adequacy, and application of accounting, financial and other internal operational controls. I currently serve as an independently appointed, outside Director on the Board of AgFirst Farm Credit Bank, a position I've held since January 2006.

As you can see by my professional history, most of my career has been spent working for agricultural cooperatives. During my 28 years in the citrus industry, I gained a deep appreciation for agricultural producers and production agriculture.

As the members of the committee are well aware, production agriculture, particularly Florida's citrus industry, is capital intensive and heavily reliant on access to competitive credit. Add in variables of the marketplace, world events, weather, and many other unforeseen factors and one can see that agriculture is a risky business. Americans and, for that matter, people around the world should be thankful for the men and women who produce the food and fiber that we enjoy daily and without which we could not survive.

As I said, production agriculture is very capital intensive. Land costs, labor, equipment, and fertilizer require long-term and short-term financing. It takes a variety of lenders to meet the credit needs of agricultural producers and their cooperatives. The Farm Credit System, which is regulated by the Farm Credit Administration, is a very important part of the coalition of lenders required to finance American agriculture.

Serving as an outside Director of the AgFirst Farm Credit Bank Board has given me a new and greater appreciation for the complexity and importance of agricultural and rural finance. I believe my 28 years of financial experience working for agricultural cooperatives would serve me well as a member of the board of the Farm Credit Administration. I would utilize that expertise to ensure the safety and soundness of the Farm Credit System so that it continues to serve the credit needs of America's farmers, ranchers, and their cooperatives.

In closing, I would like to thank the Committee for the important role it plays in the oversight and authorization of the Farm Credit System and its mission to meet the credit and related services needs of American farmers and ranchers.

That concludes my statement. I welcome your questions.

Thank you.

DOCUMENTS SUBMITTED FOR THE RECORD

SEPTEMBER 30, 2009

(67)

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used). Edward Mesa Avalos
2. Date and place of birth. November 8, 1951; Dinuba, CA
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es). Divorced
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

 New Mexico State University, College of Agriculture 1970-1974
 B.S. Agronomy 1974; B.S. Horticulture 1975;
 New Mexico State University, College of Agriculture 1995-1996
 M.A. Agriculture 1996.
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

 Texas Department of Agriculture, 1975-1980
 Amarillo, Texas
 Marketing Specialist

 New Mexico Department of Agriculture, 1980-present
 Las Cruces, New Mexico
 Director of Marketing
 Ag Marketing, Sales, and Promotion

 Eddards Construction, Inc. 1987-present
 Las Cruces, New Mexico
 Residential Construction-Construct 2-5 houses per year.
6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

 None
7. Government Service: State (chronologically) your government service or public

offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

None

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

Best Ag Marketing Project 2007-New Mexico Green Chile, North American Agriculture Marketing Officials (NAMO)

9. Other Memberships: If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

New Mexico State University Aggie Athletic Fund
Served as a board member from 2006-2007
Purpose was to raise support and funding for Aggie Athletics

Advisory Board, New Mexico State Land Office
Have been on the board since 2006. I will resign when confirmed. My role on the advisory board was to represent beneficiaries and relay their concerns, if any, to the Land Office.

Fraternal Order of Eagles, Member

New Mexico Cattle Growers Association, Associate Member

10. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

None

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes
2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None
3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)

No
4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in federal commodity income and price support programs? (If yes, provide all details including amounts of government payments and loans received or forfeited by crop and farm, et cetera during the past five years.)

No
5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any current or previously existing agency of the Department of Agriculture, including through any of the farm or rural development lending programs? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)

No
6. Have you, or any partnership or closely held corporation in which you have an interest, received payments for crop losses from the federal crop insurance program in the past 5 years? (If yes, give details.)

No
7. Have you ever received a government guaranteed student loan? If so, has it been repaid?

No

8. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No, if confirmed, I will resign as president of Eddards Construction, Inc. My son, Russell Avalos, will operate and manage the small construction company.

9. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No

10. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No

11. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

None

12. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above items. In particular, identify all investments, obligations, liabilities, or other relationships which involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

I do not see any actual or potential conflicts of interest. In connection with the nomination process, I have consulted with the Office of Government Ethics and the Department of Agriculture's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.

13. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or

potential conflicts of interest should you be confirmed to the position for which you are nominated.

In connection with the nomination process, I have consulted with the Office of Government Ethics and the Department of Agriculture's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

July 7, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Edward M. Avalos, who has been nominated by President Obama for the position of Undersecretary for Marketing and Regulatory Affairs, Department of Agriculture.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert J. Cusick".

Robert J. Cusick
Director

Enclosures

June 24, 2009

Mr. Raymond J. Sheehan, Director
USDA Office of Ethics
1400 Independence Avenue, SW
Rm 347-W J. L. Whitten Building
STOP 0122
Washington, DC 20250-0122

Dear Mr. Sheehan:

The purpose of this letter is to explain the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Under Secretary for Marketing and Regulatory Programs, U.S. Department of Agriculture. As Under Secretary of Agriculture for Marketing and Regulatory Programs, I may also hold a general membership on the Board of Directors of the Commodity Credit Corporation. The steps detailed below take into account any potential conflicts or appearances thereof associated with the Commodity Credit Corporation position also.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to section 208(b)(1), or qualify for a regulatory exemption, pursuant to section 208(b)(2). I further understand that the interests of the following persons are imputed to me: any spouse or minor child of mine, any general partner of a partnership in which I am a limited or general partner; any entity in which I serve as officer, director, trustee, general partner, or employee; and any person or entity with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position as Director, Marketing and Development Division, New Mexico Department of Agriculture. For one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the New Mexico Department of Agriculture is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

As an employee of the State of New Mexico Department of Agriculture, I currently participate in a defined benefit retirement plan operated by the New Mexico Educational Retirement Board. Upon termination of my employment relationship, my employer will cease making contributions to this plan. Under this plan, I am to receive \$4,692 per month beginning at age 57. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of New Mexico Educational Retirement Board to provide this employment benefit, unless I first obtain a written waiver pursuant to 18 U.S.C. § 208 (b)(1) or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208 (b)(2).

I also am owner and President of Eddards Construction, Inc., of Las Cruces, New Mexico. Upon confirmation, I will resign my position as President of the company. I will continue to have a financial interest in this entity, but I will not manage it or provide any other services to it. Instead, I will receive only passive investment income from it. Pursuant to 18 U.S.C. § 208 (a), I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the financial interests of Eddards Construction, Inc.

I also own four rental residential properties and one parcel of undeveloped land, all located in Las Cruces, NM. Pursuant to 18 U.S.C. § 208 (a), I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the value of these properties. Additionally, the rental properties are subject to mortgages and the undeveloped lot is subject to a repayment of a personal loan from the following entities, all located in Las Cruces, New Mexico:

- Sun Trust Mortgage
- Bank 34
- Bank of the Rio Grande

Pursuant to 5 C.F.R. § 2635.502, I will not participate personally and substantially in any particular matter involving specific parties in which any of these entities is a party or represents a party, unless I am authorized to participate.

As part of my duties as a New Mexico State employee, I also serve as Vice Chairman of the New Mexico State Land Office Advisory Board (Board). Upon confirmation, I will resign from the Board. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Board is a party or represents a party, unless I am first authorized to participate pursuant to 5 C.F.R. § 2635.502(d).

Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,



Edward M. Avalos

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | | |
|--|---|---|---|--|--|
| Date of Appointment, Candidacy Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate boxes) <input type="checkbox"/> Incumbent <input type="checkbox"/> New Hire, Nominee, or Candidate <input checked="" type="checkbox"/> Termination <input type="checkbox"/> Termination Date (If Applicable) (Month, Day, Year) | Calendar Year Covered by Report | Reporting Period (If Applicable) (Month, Day, Year) | Reporting Individual's Name Last Name: Avalon First Name and Middle Initial: Edward M. | Reporting Periods The reporting period is the preceding calendar year except for II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Position for Which Filing | Title of Position: Undersecretary for Marketing and Regulatory Programs Department or Agency (If Applicable): Agriculture | Address (Number, Street, City, State, and ZIP Code): Duplicate | Telephone No. (Include Area Code): | Reporting Periods The reporting period is the preceding calendar year except for II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. | |
| Location of Present Office (or forwarding address) | Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above): None | Presidential Nominees Subject to Senate Confirmation Name of Congressional Committee Considering Nomination: Agriculture, Nutrition, and Forestry Do You Intend to Create a Qualified Discarded Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | Certification I CERTIFY that the statements I have made on this form and all attached schedules are true, complete and correct to the best of my knowledge. Signature of Reporting Individual: Edward M. Avalos Date (Month, Day, Year): 6/24/09 | Nonincumbent, New Entrants and Candidates for President and Vice President: Schedule A - The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value dates as of any date you choose that is within 31 days of the date of filing. Schedule B - Not applicable. Schedule C, Part I (Institution) - The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 91 days of the date of filing. Schedule E - Part II (Arrangements) - Show any agreements or arrangements as of the date of filing. Schedule D - The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. | |
| Other Reviewer (If desired by agency) | Agency Ethics Official's Opinion On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below): Signature: [Signature] Date (Month, Day, Year): 6/26/09 | Office of Government Ethics Use Only Signature: [Signature] Date (Month, Day, Year): 7/7/09 | Comments of Reviewing Officials (If additional space is required, use the reverse side of this sheet) (Check box if filing extension granted & indicate number of days) <input type="checkbox"/> | Agency Use Only OIG Use Only JUL 16 2009 | |

76

Form 1041-100 (1-81)
 Schedule A
 Supplemental Information

| Schedule A | | Supplemental Information | | | | | | | | | | Total | | | |
|-----------------|---|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--|--|--------|---------|
| Year and Income | Value of Assets at Close of Reporting Period (See K7) | Increase, decrease or net change in value of assets (See instructions for Part A) | | | | | | | | | | Total Increase, Decrease or Net Change | Total Value of Assets at Close of Reporting Period | | |
| | | Part A | Part B | Part C | Part D | Part E | Part F | Part G | Part H | Part I | Part J | | | Part K | |
| 1981 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1982 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1983 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1984 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1985 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1986 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1987 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1988 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1989 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1990 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1991 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1992 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1993 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1994 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1995 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1996 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1997 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1998 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 1999 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2000 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2001 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2002 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2003 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2004 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2005 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2006 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2007 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2008 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2009 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2010 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2011 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2012 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2013 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2014 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2015 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2016 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2017 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2018 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2019 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2020 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2021 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2022 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2023 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2024 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2025 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2026 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2027 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2028 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2029 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |
| 2030 | 100,000 | 100,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 100,000 |

Edward M. Azusa

SCHEDULE A continued

2

(Use only if needed)

| BLOCK A | BLOCK B | | | | | | | | | | BLOCK C | | Other income (do not check any boxes) | Date (M., Day, Yr.) | Date of Reacquisition | | | |
|---|--|-------------|------------|-------------|--------------------|----------------|--------------|-------|--------------------------|--------------------------|--|--------------------------|---------------------------------------|--------------------------|--------------------------|--------------------------|-----------|-----------|
| | Valuation of Assets at close of reporting period | | | | | | | | | | Income type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for this item. | | | | | | | |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | | |
| | Other | Real estate | Securities | Partnership | Private foundation | Art collection | Collectibles | Other | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | | |
| <input type="checkbox"/> None | | | | | | | | | | | | | | | | | | |
| New Mexico Education Endowment Board | | | | | | | | | | | | | | | | | 10/1/2009 | 10/1/2009 |
| United Methodist Church | | | | | | | | | | | | | | | | | 10/1/2009 | 10/1/2009 |
| Undeveloped lot in Concord, NM | X | | | | | | | | | | | | | | | | | |
| Edwards Construction, Inc. in Concord, NM | X | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | |

This category applies only if the asset is not a security that of the trust's spouse or dependent child. If the asset is none of these, the filer or jointly held by the filer with the spouse or dependent child, mark the other block with "None for less than \$201" or appropriate.

Reporting Individual's Name: Edward M. Avalos

SCHEDULE D

Page Number: 5

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with titles such as social, fraternal, or political entities and those solely of an honorary nature.

| Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) | None <input type="checkbox"/> |
|--|----------------------------------|----------------------|-----------------|-----------------|-------------------------------|
| Examples: Nat'l Assn. of Book Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 6/92 7/85 | Present 1/00 | |
| 1 New Mexico Department of Agriculture | State Agency | Director-Marketing | 6/80 | Present | |
| 2 Eddards Construction, Inc., Las Cruces, NM | S Corporation | President | 7/87 | Present | |
| 3 New Mexico State Land Office-Advisory Board | Residential Construction | Vice Chairman | 2006 | Present | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source. Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate.

| Source (Name and Address) | Brief Description of Duties | None <input type="checkbox"/> |
|--|---|-------------------------------|
| Examples: Doe Jones & Smith, Hometown, State Metro University (client of Doe Jones & Smith), Monroeville, State | Legal services Legal services in connection with university construction | |
| 1 New Mexico Department of Agriculture | State Government Agency | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used.

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).

Bart Hamilton Chilton, Bartholamew Chilton

2. Date and place of birth.

(b)(6) *Wilmington, Delaware, USA*

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).

Spouse: Sherry Chilton (formerly, Sherry Daggett, Sherry Hayes)
Occupation: Management Executive (retired from Ernst and Young LLP)

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

Purdue University 1979-1982

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

| | | |
|------------------|---|--------------------------------|
| <i>1983</i> | <i>City of Fort Wayne, Indiana</i> | <i>Aide to the Mayor</i> |
| <i>1983-84</i> | <i>Mondale for President</i> | <i>Field Organizer</i> |
| <i>1985-86</i> | <i>U.S. Hse. of Reps. Hon. Terry Bruce</i> | <i>Legislative Assistant</i> |
| <i>1987-89</i> | <i>U.S. Hse. of Reps. Hon. Jim Jontz</i> | <i>Legislative Director</i> |
| <i>1989-94</i> | <i>U.S. Hse. of Reps. Hon. Jill Long</i> | <i>Legislative Director</i> |
| <i>1995</i> | <i>U.S. Hse. of Reps. Hon. Earl Pomeroy</i> | <i>Legislative Director</i> |
| <i>1995-1999</i> | <i>U.S. Dept. of Agriculture</i> | <i>Policy Dir. Rurol Dev.</i> |
| <i>1999-2001</i> | <i>U.S. Dept. of Agriculture</i> | <i>Deputy Chief of Staff</i> |
| <i>2001</i> | <i>Bion Environmental Technologies</i> | <i>Vice President</i> |
| <i>2001-05</i> | <i>U.S. Senate Hon. Tom Daschle</i> | <i>Sen. Policy Advisor</i> |
| <i>2005-06</i> | <i>U.S. Farm Credit Administration</i> | <i>Assistant to the Board</i> |
| <i>2006-07</i> | <i>National Farmers Union</i> | <i>Chief of Staff/VP Govt.</i> |
| <i>2006-07</i> | <i>Association of Family Farms</i> | <i>Director/Treasurer</i> |
| <i>2006-07</i> | <i>Bion Environmental Technologies</i> | <i>Board Member</i> |
| <i>2007-09</i> | <i>Commodity Futures Trading Commission</i> | <i>Commissioner</i> |

6. **Military Service:** Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

No.

7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

| | | |
|-----------|--------------------------------------|----------------------|
| 1985-86 | U.S. Hse. of Reps. Hon. Terry Bruce | Salaried Employee |
| 1987-89 | U.S. Hse. of Reps. Hon. Jim Jontz | Salaried Employee |
| 1989-94 | U.S. Hse. of Reps. Hon. Jill Long | Salaried Employee |
| 1995 | U.S. Hse. of Reps. Hon. Earl Pomeroy | Salaried Employee |
| 1995-1999 | U.S. Dept. of Agriculture | Schedule C (GS-15) |
| 1999-2001 | U.S. Dept. of Agriculture | Senior Exec. Service |
| 2001-05 | U.S. Senate Hon. Tom Daschle | Salaried Employee |
| 2005-06 | U.S. Farm Credit Administration | Schedule C |
| 2007-09 | Commodity Futures Trading Commission | Commissioner |

8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None.

9. **Political Affiliation:** The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Democrat.

10. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

Board Member for the following:

- Columbia Beach Citizens Improvement Association (volunteer position)*
- Association of Family Farms (volunteer position)*

11. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum

extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

All of the speeches, remarks and statements may be found at cftc.gov

September 21, 2009 Statement of Commissioner Bart Chilton Regarding the CFTC Investigation of Silver Markets, Commodity Futures Trading Commission

September 15, 2009 Speech of Commissioner Bart Chilton, "Moment of Inertia", Institutional Investors Carbon Forum

September 4, 2009 Statement of Commissioner Bart Chilton on CFTC's New Transparency Initiatives, Commodity Futures Trading Commission

September 2, 2009 Statement of Commissioner Bart Chilton, Joint Meetings on Harmonization of Regulation

August 11, 2009 Statement by Commissioner Bart Chilton, "The Right Road to Reform", Commodity Futures Trading Commission

August 4, 2009 Speech of Commissioner Bart Chilton, "Sense of Balance", American Public Gas Association Annual Meeting

July 28, 2009, Statement by Commissioner Bart Chilton, Commodity Futures Trading Commission

July 7, 2009 Statement of CFTC Commissioner Bart Chilton on Speculative Limit Hearings and Increased Transparency, CFTC

June 24, 2009 Speech of Commissioner Bart Chilton, "Picture Puzzles", Third Annual International Commodity Markets, Manipulation Enforcement Conference

June 18, 2009 Statement of Commissioner Bart Chilton on the Administration's Plan for Financial Regulatory Reform, CFTC

June 11, 2009 Speech of CFTC Commissioner Bart Chilton, "Green CAT" Markets: You Gotta Show Some Guts, Chicago Climate Exchange & Chicago Climate Futures Exchange, Sixth Annual Meeting May 20, 2009, Statement of Commissioner Bart Chilton Regarding CFTC Commissioners, Commodity Futures Trading Commission

May 13, 2009, Statement of Commissioner Bart Chilton on Regulatory Reforms for OTC Markets, Commodity Futures Trading Commission

April 29, 2009, Remarks of Commissioner Bart Chilton to the New York Regional Office: "The Luckier We Get", Commodity Futures Trading Commission

March 20, 2009, Remarks of Commissioner Bart Chilton to the American Bar Association: "Ponzimonium", Commodity Futures Trading Commission

February 10, 2009, Remarks by Commissioner Bart Chilton: "The Commodity Coaster", Washington Agricultural Roundtable, Brookings Institution

February 4, 2009, Statement of Commissioner Bart Chilton Regarding House Agriculture Committee Futures Industry Oversight Hearings and Consideration of Legislation to Improve Regulation of Futures and Derivatives Markets, Commodity Futures Trading Commission

January 28, 2009, Speech by Commissioner Bart Chilton: "Years That Answer", International Quality Productivity Center, 3rd Carbon Trading Conference

December 18, 2008, Statement of Commissioner Bart Chilton Regarding the Nomination of Gary Gensler, Commodity Futures Trading Commission

December 12, 2008, Remarks of Commissioner Bart Chilton: "Driving on Ice", European Union Agriculture and Financial Market Attachés, French Embassy

November 19, 2008, Speech by Commissioner Bart Chilton: "Banquet of Consequences", Environmental Markets Association 12th Annual Fall Conference

November 14, 2008, Statement of Commissioner Bart Chilton Regarding Central Counterparties for Credit Default Swaps, Commodity Futures Trading Commission

November 11, 2008, Statement of Commissioner Bart Chilton, Commodity Futures Trading Commission

October 28, 2008, Statement of Commissioner Bart Chilton Regarding CFTC/SEC Merger, Commodity Futures Trading Commission

October 8, 2008, Statement of Commissioner Bart Chilton on Regulation of Credit Default Swaps, Commodity Futures Trading Commission

September 17, 2008, Opening Remarks by Commodity Futures Trading Commission Commissioner Bart Chilton, CFTC Cooperative Enforcement Conference

August 14, 2008, Remarks of Commissioner Bart Chilton: "A Photographer's Eye", Michigan Agri-Business Association

July 29, 2008, Opening Statement of Commissioner Bart Chilton: "Our Progressive Discovery", Agricultural Advisory Committee, Commodity Futures Trading Commission

July 15, 2008, Statement of Commissioner Bart Chilton Regarding Global Markets Advisory Committee, Commodity Futures Trading Commission

June 25, 2008, Speech by Commissioner Bart Chilton: "The Most Important Thing", Finance IQ, Second Carbon Trading Conference

June 13, 2008, Statement of Commissioner Bart Chilton on the Increasing Transparency and Accountability in Oil Markets Act, Commodity Futures Trading Commission

June 10, 2008, Remarks of Commissioner Bart Chilton, Energy Markets Advisory Committee, Commodity Futures Trading Commission

April 29, 2008, Speech by Commissioner Bart Chilton: "Wicked Awesome" Financial Regulation, National Futures Association

April 22, 2008, Statement of Commissioner Bart Chilton: "Heartburn in the Heartland", Agricultural Markets Roundtable, Commodity Futures Trading Commission

April 21, 2008, Speech by Commissioner Bart Chilton: "The Ancient Art of Glassmaking", Future and Options Association, London, England

April 16, 2008, Statement by Commissioner Bart Chilton Regarding the President's Remarks on Climate Change, Commodity Futures Trading Commission

April 15, 2008, Remarks by Commissioner Bart Chilton: "We Can Do Better", Commodity Futures Trading Commission

April 10, 2008, Remarks by Commissioner Bart Chilton: "It's Not Easy Being Green ... Markets in the US", Carbon Roundtable

March 30, 2008, Statement of Commissioner Bart Chilton on Treasury Blueprint, Commodity Futures Trading Commission

March 28, 2008, Statement of Commissioner Bart Chilton regarding Secretary Paulson's Treasury Department Blueprint on Regulatory Reform, Commodity Futures Trading Commission

March 17, 2008, Statement of Commissioner Bart Chilton Regarding NYMEX Emissions Trading, Commodity Futures Trading Commission

March 11, 2008, Statement of Commissioner Bart Chilton Regarding CFTC-SEC Cooperation, U.S. Securities and Exchange Commission

February 27, 2008, Remarks by Commissioner Bart Chilton: "Properties of Bamboo", Futures Industry Association of Asia, Hong Kong

February 8, 2008, Speech by Commissioner Bart Chilton: CFTC's 'American Idols': Reality Regulation, Commodity Markets Council

December 6, 2007, Remarks by Commissioner Bart Chilton: "A Time for Every Purpose", Agricultural Advisory Committee Meeting, Commodity Futures Trading Commission

November 29, 2007, Remarks by Commissioner Bart Chilton: "A Better Understanding: Current Issues with SEC: Exempt Commercial Market Regulation", Futures Industry Association Expo Conference, Washington Regulators' Panel

November 13, 2007, Speech by Commissioner Bart Chilton: "Let's Not 'Dial M for Merger': CFTC's Principles-Based Regulation – A Success Story", Futures Industry Association, Law and Compliance Luncheon

November 6, 2007, Speech by Commissioner Bart Chilton: "CFTC and Energy Markets: The Cop on the Beat – Protecting Consumers", American Public Gas Association

October 16, 2007, Speech by Commissioner Bart Chilton: "Not Your Father's Regulator", Futures Industry Association, Law and Compliance Luncheon

September 18, 2007, Remarks by Commissioner Bart Chilton: "Dark Markets," Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets, Commodity Futures Trading Commission

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes.

2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None.

3. Have you ever received a government guaranteed student loan? If so, has it been repaid?

Yes. It has been paid in full.

4. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No.

5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No.

6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No.

7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.

None.

8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above

items. In particular, identify all investments, obligations, liabilities, or other relationships which involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

There are no such conflicts or potential conflicts. Should such a conflict or potential conflict arise, I will consult with the designated agency ethics officer and take any steps necessary to resolve it.

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.

None.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

May 26, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Bart H. Chilton, who has been nominated by President Obama for the position of Commissioner, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures



U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581
www.cftc.gov

Bart Chilton
Commissioner

(202) 418-5060
(202) 418-5620 Facsimile
bchilton@cftc.gov

April 1, 2009

Mr. John P. Dolan
Counsel and Alternate Designated Ethics Official
Office of the General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

This letter describes the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Commissioner for the Commodity Futures Trading Commission ("CFTC").

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver pursuant to section 208(b)(1) or qualify for a regulatory exemption pursuant to section 208(b)(2). I understand that the interests of the following persons are imputed to me: my spouse and minor children; any general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

John Dolan
Page 2

Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,

A handwritten signature in black ink, appearing to be "Bart H. Chilton", written over a horizontal line.

Bart H. Chilton

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | | | | | |
|---|---|--|---|--|--|---|---|---|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | Reporting Status (Check Appropriate Boxes) | Incumbent <input type="checkbox"/> | Calendar Year Covered by Report | New Entrant, Nominee, or Candidate <input checked="" type="checkbox"/> | Termination Filer <input type="checkbox"/> | Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period, shall be subject to a \$200 fee. | |
| Reporting Individual's Name | Last Name Chilton | First Name and Middle Initial Bart H | | | | | | |
| Position for Which Filing | Title of Position Commissioner | Department or Agency (If Applicable) Commodity Futures Trading Commission | | | | | | Reporting Periods Incumbents: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) | Address (Number, Street, City, State, and ZIP Code) Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581 | | Telephone No. (Include Area Code) 202.418.5080 | | | | | |
| Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | Title of Position(s) and Date(s) Held Commissioner, CFTC August 14, 2007 to Present | | | | | | Termination Filer: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. | |
| Presidential Nominations Subject to Senate Confirmation | Name of Congressional Committee Considering Nomination Committee on Agriculture, Nutrition and Forestry | | Do You Intend to Create a Qualified Diversified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | | | | |
| Certification | Signature of Reporting Individual | | Date (Month, Day, Year) | | Schedule A - The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. | | | |
| Other Review (If Desired by Agency) | Signature of Reviewer | | Date (Month, Day, Year) | | Schedule B - Not applicable. | | | |
| Agency Ethics Official's Opinion | Signature of Designated Agency Ethics Official/Reviewing Official | | Date (Month, Day, Year) | | Schedule C, Part I (Liabilities) - The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. | | | |
| Office of Government Ethics Use Only | Signature | | Date (Month, Day, Year) | | Schedule C, Part II (Agreements or Arrangements) - Show any agreements or arrangements as of the date of filing. | | | |
| Comments of Reviewing Officials (If additional space is required, use the reverse side of this sheet) | | | | | | | Schedule D - The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. | |
| (Check box if filing extension granted & indicate number of days) <input type="checkbox"/> (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | | | | | | |
| Agency Use Only OGE Use Only MAY 20 2009 | | | | | | | 93 | |

99 of 308

Reporting Individual's Name
 Chilton, Bart H.

SCHEDULE A

Page Number
 1 of 8

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | | | | |
|---|---|-------------------|--------------------|---------------------|---------------------|------------------|--------------------|----------------------------|-------------------|--------------------------|--------------|--|-----------|----------|---------------------------|-----------|---------------|------------------|-------------------|--------------------|------------------|--------------------|--|---|--|--|
| | | | | | | | | | | | | Type | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | |
| | | | | | | | | | | | | Amount | | | | | | | | | | | | | | |
| For you, your spouse, and dependent children, report each asset held for investment or the production of income which had a fair market value exceeding \$1,000 at the close of the reporting period, or which generated more than \$200 in income during the reporting period, together with such income. For yourself, also report the source and actual amount of earned income exceeding \$200 (other than from the U.S. Government). For your spouse, report the source but not the amount of earned income of more than \$1,000 (except report the actual amount of any honoraria over \$200 of your spouse). None <input type="checkbox"/> | \$1-\$15,000 | \$15,000-\$50,000 | \$50,000-\$100,000 | \$100,000-\$250,000 | \$250,000-\$500,000 | Over \$500,000 + | Over \$1,000,000 + | \$5,000,001 - \$13,999,999 | Over \$50,000,000 | Excluded Investment Fund | Exempt Trust | None | Dividends | Interest | None (or less than \$201) | \$1-\$100 | \$101-\$1,000 | \$1,001-\$15,000 | \$15,001-\$50,000 | \$50,001-\$100,000 | Over \$100,000 + | Over \$1,000,000 + | Over \$5,000,000 | | | |
| Examples | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

100 of 308

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | | Page Number | | | | | | | | |
|------------------------------|---|----------------------|--|--|--|--|--|--|--|--|---|--|----------|-------------|---------------------------|--|---|--------------------------|----------------------------|----------------|--|---------------|
| Chilton, Bart H. | | (Use only if needed) | | | | | | | | | | | | 2 of 6 | | | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: Type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | | |
| | | | | | | | | | | | BLOCK C | | | | | | | | | | | |
| | | | | | | | | | | | | | Type | Amount | | | | | | | | |
| | | | | | | | | | | | | | Dividend | Interest | None (or less than \$201) | Over \$1,000 - \$14,999 | Over \$15,000 - \$49,999 | Over \$50,000 - \$99,999 | Over \$100,000 - \$499,999 | Over \$500,000 | | |
| 1 | IWN-ISHARES TR Russell 2000 Value | X | | | | | | | | | | | | | | | | | | | | |
| 2 | IWO-ISHARES TR Russell 2000 Growth | X | | | | | | | | | | | | | | | | | | | | |
| 3 | SBSPX Legg Mason Partners S&P 500 | X | | | | | | | | | | | | | | | | | | | | |
| 4 | Smith Barney "XCABX" Scholars Choice Equity 80% 529 Plan CUSIP # 80705P294000 | X | | | | | | | | | | | | | | | | | | | | |
| 5 | Drayfus Money Market CUSIP # 262016108000 | X | | | | | | | | | | | | | | | | | | | | |
| 6 | Ernst & Young, LLP | | | | | | | | | | | | | | | | | | | | | Spouse Salary |
| 7 | Ernst & Young, LLP -401(K) --Fidelity Magellan Class K (FMGKX) | | | | | | | | | | | | | | | | | | | | | |
| 8 | Ernst & Young, LLP -401(K) --Fidelity Low Price (MCV) | | | | | | | | | | | | | | | | | | | | | |
| 9 | ALEX RVS Large Cap Large Cap Equity Fund Class A | X | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.
 - Prior Editions Cannot be Used

95

101 of 308

Reporting Individual's Name

Chilton, Bert H.

SCHEDULE A continued

(Use only if needed)

Page Number

3 of 6

| BLOCK A | BLOCK B | | | | | | BLOCK C | | | | | | | | | | Other Income Category Type & Actual Amount | Date (Mo., Day, Yr.) Only if Honorary | | | | | | | | | | | |
|-------------------------------|---|--|---------------------|--|----------------------|--|--|--|-------------------|--|----------------|--|-----------|--|----------|--|--|---------------------------------------|---------------------------|--|-------------------|--|-------------------|--|--------------------|--|----------------------|--|-------------------|
| | Valuation of Assets at close of reporting period | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | | | | | | | | | | | |
| | \$1,001 - \$15,000 | | \$15,001 - \$50,000 | | \$50,001 - \$100,000 | | Over \$1,000,000* | | Over \$50,000,000 | | Exempted Trust | | Dividends | | Interest | | | | None (or less than \$201) | | \$1,001 - \$1,500 | | \$1,501 - \$5,000 | | \$5,001 - \$10,000 | | \$10,001 - \$100,000 | | Over \$1,000,000* |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | Ernst & Young, LLP -- 401(K) -- Fidelity Balance | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | Ernst & Young, LLP -- 401(K) -- Dodge & Cox Stock (DODGX) | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | Ernst & Young, LLP -- 401(K) -- American Funds Europac Growth R5 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | Ernst & Young, LLP -- 401(K) -- Managers Fremont Bond | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | Vanguard Target RET 2015 Inv. CL (VTXX) | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.

Printed on Recycled Paper

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: **Chilton, Bart H.** Page Number: **4 of 6**

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| | Identification of Assets | Transaction Type (x) | Date (Mo., Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | | | |
|---|----------------------------------|----------------------|----------------------|---------------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|---------------------------|---------------------------|----------------------------|-------------------|-------------------|----------------------------|--|
| | | | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$2,500,000 | \$2,500,001 - \$5,000,000 | \$5,000,001 - \$10,000,000 | Over \$10,000,000 | Over \$50,000,000 | Certificate of Divestiture | |
| 1 | Example: Central Airlines Common | x | 2/1/99 | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Source (Name and Address) | Brief Description | Value |
|--|--|----------------|
| Examples: Nat'l Assn. of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room, & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

Prior Filings Cannot Be Used.

103 of 308

| | | |
|---|-------------------|-----------------------|
| Reporting Individual's Name Chilton, Bart H. | SCHEDULE D | Page Number 6 of 6 |
|---|-------------------|-----------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|--|------------------------------|------------------|-----------------|---------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6/92 | Present |
| | Doc Jones & Smith, Hometown, State | Law firm | Partner | 7/85 | 1/06 |
| 1 | Farmers Educational & Cooperative Union of America | Non-Profit Trade Association | Chief of Staff | 06/2008 | 08/2007 |
| 2 | Association of Family Farms | 510(c)(3) | Director/Officer | 10/2006 | 08/2007 |
| 3 | Bion Environmental Technologies | For Profit Company | Director | 10/2006 | 08/2007 |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate
 None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|--|---|
| Examples: | Doc Jones & Smith, Hometown, State | Legal services |
| | Metro University (client of Doc Jones & Smith), Moesytown, State | Legal services in connection with university construction |
| 1 | Farmers Educational & Cooperative Union of America | Chief of Staff |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Print Editions Cannot Be Used.

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).
Scott Douglas O'Malia
2. Date and place of birth.
(b)(6) **South Bend, IN**
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).
Married
Marissa Reyes O'Malia, formerly Marissa Jane Reyes
Doctor of Chiropractic
Dr. Marissa R. O'Malia, P.C.
2440 M Street, NW #807, Washington, D.C. 20037
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.
9/85-12/86 Lansing Community College, Kyoto Education Center Japan
1/87-5/90 University of Michigan, Ann Arbor, BA LSA 5/4/90
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

Public Securities Association -- 1990-1991
Assistant Political Manager
Managed PSA PAC activities that included fundraising, correspondence, Federal Election Commission filing, and special events. Drafted weekly updates on political events for industry newsletter.

Senator McConnell -- 1991-2001
Legislative Staff
Responsible for appropriations as well as energy, environment, education, tax policy, and commercial policy issues.

Mirant -- 2001 - 2003
Director
Developed a policy organization within Mirant and financial trade associations to bring together commercial interests, investor relations and legal staff to review federal legislative initiatives and develop the appropriate policy response. Also worked with international business units regarding merger activity and terrorism insurance.

U.S. Senate Energy Committee -- 2003-2004**Professional Staff**

Developed policies related to oil and natural gas markets including conducting congressional hearings and drafting legislative initiatives.

Energy and Water Development Subcommittee, Committee on Appropriations -- 2004-Present**Clerk**

Responsibilities include drafting and passage of the Energy and Water Development appropriation legislation providing funding to the Department of Energy (\$26 billion budget), U.S. Army Corps of Engineers (\$ 5.3 billion budget), and Bureau of Reclamation (\$1 billion budget).

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.
No Military Service
7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.
**U.S. Senator McConnell
U.S. Senate Committee on Energy and Natural Resources
U.S. Senate Committee on Appropriations**
8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.
Worker Health Protection Program Award 2006 -- For assistance to Department of Energy Defense Nuclear Workers
9. Political Affiliation: The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.
Republican
10. Other Memberships: If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.
**Key School PTA, Arlington VA
Gunston Middle School PTA, Arlington, VA
Stennis Fellows, Washington, D.C.**
11. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please

include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

N/A

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?
Yes
2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.
**Mirant warrants provided on 1/3/06. Qty: 119 Warrants - \$1768 value,
Mirant stock Qty: 37 shares - \$661 value
Attachment: Conflict of Interest letter**
3. Have you ever received a government guaranteed student loan? If so, has it been repaid?
No
4. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)
No
5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)
No
6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)
No
7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.
No
8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.
Attachment: Conflict of Interest Letter

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.
Attachment: Conflict of Interest Letter



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

September 18, 2009

The Honorable Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Scott D. O'Malia, who has been nominated by President Obama for the position of Commissioner, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures

August 31, 2009

Mr. John P. Dolan
Counsel and Alternate Designated
Agency Ethics Official
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

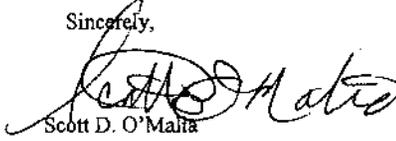
In regard to your review of my public financial disclosure report ("SF 278") and in anticipation of my nomination by President Obama, I wish to advise you of the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed as Commissioner of the Commodity Futures Trading Commission.

As required by 18 U.S.C. 208 (a), I will not participate personally or substantially in any particular matter that has a direct and predictable effect on my financial interest or those of any person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. 208 (b)(1), or qualify for a regulatory exemption pursuant to 18 U.S.C. 208 (b)(2). I understand that the interests of the following person are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

I own warrants for shares of Mirant Corporation common stock. Within 90 days of confirmation, I will divest my warrants in the Mirant Corporation because ownership of this security is a prohibited interest pursuant to CFTC's Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission at 17 C.F.R. § 140.735-2a(b)(2). If I divest the warrants by exercising them, I will also divest the resulting stock within 90 days of my confirmation. Until this divestiture has been completed, I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the financial interests of Mirant Corporation.

Finally I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to commitments I have made in this and any other ethics agreement.

Sincerely,



Scott D. O'Malia

Reporting Individual's Name: **Scott D. O'Malia** Page Number: **3**

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day, Yr.) Only if Honorary | |
|--|---|--------------------|---------------------|----------------------|-----------------------|-------------------------|------------------|---|-----------------|-------------------|--------------------|---------------------|---------------------|----------------------|----------------|------------------|------------------|--|--|
| | | | | | | | | BLOCK C | | | | | | | | | | | |
| | | | | | | | | Type | Amount | | | | | | | | | | |
| None <input type="checkbox"/> | None (or less than \$2,001) | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$1,000,000 | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | |
| 1 Eaton Vance Large Cap Value Mutual Fund EHSX | | X | | | | | | | | | | | | | | | | | |
| 2 Goldman Sachs Mid Cap Value Mutual Fund GCMAX | | | X | | | | | | | | | | | | | | | | |
| 3 Thornburg International Value Mutual Fund TGVIX | | | | X | | | | | | | | | | | | | | | |
| 4 Columbia Cash Reserve Mutual Fund NCRXX | | X | | | | | | | | | | | | | | | | | |
| 5 Target Focus Four Unit Investment Trust FTCROX | | | X | | | | | | | | | | | | | | | | |
| 6 Target Focus Four Unit Investment Trust FOCFNX | | | X | | | | | | | | | | | | | | | | |
| 7 Target Focus Four Unit Investment Trust FCUWZX | | | X | | | | | | | | | | | | | | | | |
| 8 Pimco Total Return Institutional Mutual Fund PTRX | | X | | | | | | | | | | | | | | | | | |
| 9 Columbia Marsico 21st Century Mutual Fund NMYAX | | X | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name

Scott D. O'Maha

SCHEDULE A continued
 (Use only if needed)

Page Number

5

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day, Yr.) Only if Honoraria | | | | |
|---|---|-------------------|-------------------|---------------------------|---------------------|---------------------|----------------------|-----------------------|-----------------------|----------------------|--|---|---|--------------------|---------------------|---------------------|----------------------|----------------|--|--|---|---|--|--|--|
| | | | | | | | | | | | Amount | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | | | |
| | None (or less than \$1,000) | \$1,001 - \$1,500 | \$1,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | | | | | | | |
| Type | Dividends | Interest | Capital Gains | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honoraria | | | | | | | | | | | | |
| 1 <input type="checkbox"/> None <input type="checkbox"/> MPS Value Class A Mutual Fund MEIAX Spouse | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 Bond Fund of America Mutual Fund ABNDX Spouse | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 Capital Wtd Growth VA 529 Mutual Fund CWIAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 4 Capital Income Builder VA 529 Mutual Fund CIRAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Bond Fund of America VA 529 Mutual Fund CFAAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 6 EuroPacific Growth VA 529 Mutual Fund CEUAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 7 Growth Fund of America VA 529 Mutual Fund CGFAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 8 New Perspective Fund VA 529 Mutual Fund CNPAX | | x | | | | | | | | | | | | | | | | | | | | | | | |
| 9 Washington Mutual Investor Mutual Fund CWIMAX | | x | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Peer Editors Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | |
|--|---|----------------------|---------------------------|-----------|----------|-------|--|-----------|----------|-------|--|-------------|--|---|
| Scott D. O'Malia | | (Use only if needed) | | | | | | | | | | 8 | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
| | Type | Amount | None (or less than \$201) | Dividends | Interest | Other | None (or less than \$201) | Dividends | Interest | Other | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | |
| 1 Janus Research Fund Mutual Fund JAMRX | | | | | | | | | | | | | | |
| 2 iShares Russell 2000 Value Index Fund IWRN | X | | | | | | | | | | | | | |
| 3 M&T Bank Checking/Savings | | X | | | | | | | | | | | | |
| 4 Seneca Federal Credit Union Checking/Savings | | | X | | | | | | | | | | | |
| 5 Wachovia Crown Banking-Checking | | X | | | | | | | | | | | | |
| 6 Bank of America Certificate of Deposit | | | X | | | | | | | | | | | |
| 7 Income (Spouse) Med Practice Washington, D.C. S-Corp W2 | | | | | | | | | | | | | Business Income | |
| 8 SCORP Equity (Spous) Medical Practice, Wash, D.C. Marissa R. O'Malia, PC | | | | | | | | | | | | | Business Income | |
| 9 IX Inc. Toronto Canada Comp Software, LLC | | | | | | | | | | | | | Business Income \$20,000.00 | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name
 Scott D O'Malia

SCHEDULE A continued

Page Number
 16

(Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None for less than \$2011" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|-------------------------------|---|--|--|--|--|--|--|--|--|--|---|--------|--|--|--|--|--|--|--|--|--|---|
| | BLOCK C | | | | | | | | | | Type | Amount | | | | | | | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | |
| 1 Intersil Corp | X | | | | | | | | | | | | | | | | | | | | | |
| 2 ITC Holding Corp | X | | | | | | | | | | | | | | | | | | | | | |
| 3 JPMorgan Chase & Co | X | | | | | | | | | | | | | | | | | | | | | |
| 4 JSC MMC Norikah Nickel | X | | | | | | | | | | | | | | | | | | | | | |
| 5 Kookmin BK KB: NYSE | X | | | | | | | | | | | | | | | | | | | | | |
| 6 Kroger Co | X | | | | | | | | | | | | | | | | | | | | | |
| 7 Laboratory Corp. | X | | | | | | | | | | | | | | | | | | | | | |
| 8 Lincare Holdings | X | | | | | | | | | | | | | | | | | | | | | |
| 9 Lufkin Inds Inc. | X | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 Prior Editions Cannot be Used

3521R (Rev. 03/2009)
 3-C.F.R. Part 2014
 U.S. Office of Government Ethics
 Reporting Individual's Name
 Scott D. O'Malley

Page Number
17

SCHEDULE A continued (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | BLOCK C | | Date (Mo., Day, Yr.) Only if Exceptional |
|-------------------------------|---|---------------------------|---------------------------|---------------------------|--|
| | Amount | Type | Amount | Type | |
| None <input type="checkbox"/> | | | | | |
| 1 MEMC Electronics Materials | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 2 WFS Value | \$18,001 - \$50,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 3 Macy's Inc | \$50,001 - \$100,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 4 Mattel Corp Holdings Co | \$100,001 - \$250,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 5 McDonald's Corp | \$250,001 - \$500,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 6 Inckesson Corp | \$500,001 - \$1,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 7 Marck & Co Inc | \$1,000,001 - \$250,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 8 Meridian Bioscience Inc | \$250,001 - \$500,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| 9 MetLife Inc | \$500,001 - \$1,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$1,000,001 - \$5,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Over \$1,000,000 * | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$1,000,001 - \$250,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$250,000,001 - \$500,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Over \$500,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Exceptional Investment Fund | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Excepted Trust | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Qualified Trust | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Dividends | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Real Estate | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Interest | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Capital Gains | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$201 - \$2,500 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$2,501 - \$5,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$5,001 - \$25,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$25,001 - \$50,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$50,001 - \$100,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$100,001 - \$1,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Over \$1,000,000 * | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | \$1,000,001 - \$5,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Over \$5,000,000 | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |
| | Other Income (Specify in Remarks Column) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other category.

Prior Editions Considered Void

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | Page Number | | | | | | |
|--|---|----------------------|--------------------|---------------------|---------------------|---------------|---|-----------|----------------------|----------|---------------|----------------------------|------------------|--------------------|---------------------|---------------------|---------------|---|---|
| Scott D. O'Malia | | (Use only if needed) | | | | | | | | | | | 24 | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | Income: Type and amount. If "None for less than \$2011" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | |
| | BLOCK B | | | | | | BLOCK C | | | | | | | | | | | | |
| | None (or less than \$1,000) | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | Over \$50,000 | None (or less than \$2011) | Dividends | Bank Stock Dividends | Interest | Capital Gains | None (or less than \$2011) | \$2011 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | Over \$50,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honoraria |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | |
| 1 Zenith National | X | | | | | | | | | | X | | | | | | | | |
| 2 CRM Mid Cap Value | X | | | | | | | | | | X | | | | | | | | |
| 3 U.S. Treasuries - Variety 6 Month - 30 yrs | | X | | | | | | | X | | | X | | | | | | | |
| 4 Columbia Cash Reserves Money Market Account Spouse | X | | | | | | | | X | | | | | | | | | | |
| 5 William Blair International Mutual Fund Spouse | X | | | | | | | | | | | X | | | | | | | |
| 6 Brandywine Blue Mutual Fund Spouse | X | | | | | | | | | | X | | | | | | | | |
| 7 Forward Small Cap Equity Mutual Fund Spouse | X | | | | | | | | | | X | | | | | | | | |
| 8 Janus Mid Cap Value Institutional Mutual Fund Spouse | X | | | | | | | | | | X | | | | | | | | |
| 9 RS Global Natural Resources Class A Mutual Fund Spouse | X | | | | | | | | | | X | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 * Prior Editions Cannot Be Used

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Scott D. O'Maha Page Number 28

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| Identification of Asset | Transaction Type (s) | | | Date (mo., Day, Yr.) | Amount of Transaction (s) | | | | | | | | | | | | | |
|------------------------------------|----------------------|------|----------|----------------------|---------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | Purchase | Sale | Exchange | | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 | \$1,001 - \$1,000 |
| Example: Central Airlines Contract | ✓ | | | 3/1/99 | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude reimbursements to you by the U.S. Government; gifts to your agency in connection with official travel; received from relatives; received by your spouse or dependent child solely independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Source (Name and Address) | Brief Description | Value |
|--|---|----------------|
| Examples: Hal Asan, of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airfare ticket, hotel room & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

For Editors' Use Only

133

139 of 308

Reporting Individual's Name
 Scott D. O'Malia

SCHEDULE C

Page Number
 28

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out, loans secured by automobiles, household furniture or appliances, and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None

Category of Account or Value (X)

| Creditor (Name and Address) | Type of Liability | Date Incurred | Interest Rate | Term if applicable | Category of Account or Value (X) | | | | | | | | | | | | | | | | |
|---|---|---------------|---------------|--------------------|----------------------------------|---------------------|---------------------|---------------------|-----------------------|-----------------------|-----------------------|---------------------------|---------------------------|---------------------------|----------------------|--|--|--|--|--|--|
| | | | | | < \$10,000 | \$10,000 - \$24,999 | \$25,000 - \$49,999 | \$50,000 - \$99,999 | \$100,000 - \$249,999 | \$250,000 - \$499,999 | \$500,000 - \$999,999 | \$1,000,000 - \$2,499,999 | \$2,500,000 - \$4,999,999 | \$5,000,000 - \$9,999,999 | \$10,000,000 or more | | | | | | |
| Examples: First District Bank, Washington, DC John Jones, 1233 St., Washington, DC | Mortgage on rental property, Delaware Professional fee | 1998 1999 | 8% 10% | 25 yrs undated | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits.

None

| Status and Terms of any Agreement or Arrangement | Parties | Date |
|--|------------------------------------|------|
| Example: Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/30/02 | Doe Jones & Smith, Hometown, State | 7/01 |
| 1 Mirant Warrants (119 units) will be divested | Mirant | 1/06 |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Precedence Cannot Be Used

135

141 of 308

| | | |
|--|-------------------|-------------------|
| Reporting Individual's Name Scott D. O'Malley | SCHEDULE D | Page Number 29 |
|--|-------------------|-------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|--|----------------------------------|----------------------|-----------------|-----------------|
| Examples: | Nat'l Assn. of Rock Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 6/92 7/85 | Present 1/00 |
| 1 | | | | | |
| 2 | | | | | |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |
| 7 | | | | | |
| 8 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate.
 None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|---|---|
| Examples: | Doe Jones & Smith, Hometown, State Metro University (Client of Doe Jones & Smith), Hometown, State | Legal services Legal services in connection with university construction |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |
| 7 | | |
| 8 | | |

Prior Editions Cannot Be Used

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used):

Harris Daniel Sherman

2. Date and place of birth:

(b)(6) **Denver, Colorado**

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name, and business address(es).

Divorced.

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

Colorado College, 1960-1964, B.A. (History), 1964.

Columbia University Law School, 1964-1967, LL.B, 1967

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college. Please include title and brief job description for each.

VISTA, Attorney (working with community organizations in Chicago)—1967-1968.

Chicago Public Schools, Teacher (5th Grade)—1968-1969.

Sherman, Sherman, & Morgan, Attorney (general law practice in Denver, Co.)—1969-1974.

Environmental Defense Fund, Attorney (environmental law practice in Denver, Co.)—1973-1975.

Colorado Department of Natural Resources, Executive Director (appointed by Governor Richard Lamm to oversee Colorado's energy, wildlife, water, parks, and state land programs)—1975-1980.

Arnold & Porter, Partner (specializing in natural resources, environmental, public lands, water, and American Indian law in Denver, Co.)—1980-2007.

Colorado Department of Natural Resources, Executive Director (appointed by Governor Bill Ritter to oversee Colorado's energy, wildlife, water, parks, forestry, and state lands programs)—2007-Present.

6. **Military Service:** Have you served in the military? If so, please give particulars, including the dates, branch of service, rank or rate, and type of discharge received.

No.

7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.

VISTA Attorney—1967-1968.

Colorado Department of Natural Resources, Executive Director, 1975-1980 (Appointed).

Colorado Department of Natural Resources, Executive Director, 2007-Present (Appointed).

8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

Phi Beta Kappa

Pi Gamma Mu

Woodrow Wilson Fellowship (Honorable Mention).

Honorary Doctorate of Laws, Colorado College

Thorne Ecological Institute, Environmental Award

American Bar Association, Fellow

9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

The Boettcher Foundation, Trustee, 2004- Present

Colorado College, Trustee, 1998-2005

Denver Water Board, Commissioner, 2005-2007

Colorado Forum, Member, 1986 - 2007

Trust For Public Land (National Advisory Council), 1990-2007

Trust For Public Land (Chair, Colorado Advisory Council), 1996-2007

Denver Regional Air Quality Council, Chair

Wirth Chair, University of Colorado, Trustee, 2004-2007

A & P Realty Associates, General Partnership, 1982-Present

10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include in this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you would provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry, or any other matters within the jurisdiction of this Committee or the Department of Agriculture.

See Attachment A

I do not use prepared text for my speeches, but I have included a list of my public speaking events.

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, partnerships, associations, or other organizations? (If no, provide full details.)

Yes. Please note that while I have severed all ties with my previous law firm, Arnold & Porter, I receive monthly payments from Arnold & Porter under its retirement plan. This is described in greater detail in response to Question #2

below.

2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits that you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

Arnold & Porter Retirement Plan (unfunded retirement benefits arising from the Firm's Partnership Agreement). 2009 annual anticipated receipts will be approximately \$194,000.

State of Colorado PERA (upon leaving State employment, I will receive \$350 a month).

3. Do you, or any partnership or closely held corporation or other entity in which you have an interest, own or operate a farm or ranch? (If yes, provide a brief description including location, size, and type of operation.)

Since 1981, I have owned a one-third interest in a 450 acre ranch in Summit County, Colorado. Two other families own the remaining two-thirds interest. The entire ranch is subject to a conservation easement held by the American Farmland Trust. Under the terms of the conservation easement, the property cannot be developed beyond the existing home sites. Limited grazing of horses and cattle occur through a lease with the adjacent rancher. We receive no income under the lease although we have a reciprocal arrangement whereby we can recreate on the adjacent ranchers property and he agrees to maintain our ditches and headgates. The property is not held for investment purposes.

4. Have you, or any partnership or closely held corporation or other entity in which you have an interest, ever participated in federal commodity income and price support, disaster, conservation, or related programs? (If yes, provide full details, including descriptions and amounts of payments and loans received or forfeited relating to each commodity, crop, farm, and ranch involved during the past five years.)

No.

5. Have you, or any partnership or closely held corporation or other entity in which you have an interest, received payments for crop or livestock losses from the federal crop insurance program in the past five years? (If yes, provide full details and amounts.)

No.

6. Have you ever received a student loan or loans? If so, has all indebtedness been

fully repaid? (If no, provide full details.)

No.

7. Have you, or any partnership or closely held corporation or other entity in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any department or agency of the federal government (other than a student loan), including, for example, through the farm or rural development lending programs of the Department of Agriculture or through the Small Business Administration? (If yes, provide the current status and details of such loan or loans, whether the indebtedness has been fully repaid, and all details of any such loan activity.)

No.

8. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain fully.)

No.

9. Do you have any plans to resume employment, affiliation, or practice with any of your previous employers, business firms, partnerships, associations, or other organizations after completing government service? (If yes, provide full details.)

No.

10. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, provide full details.)

No.

11. Describe fully all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

See Attachment B.

12. Explain in detail how you will resolve and avoid any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relating to the position for which you have been nominated and what actions you will take to resolve and avoid these actual or potential conflicts of interest.

Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department of Agriculture's designated agency ethics official and that has been provided to this Committee.

13. Fully describe and explain all divestitures or arrangements of any nature with respect to any type of interest that you have made or will make to resolve and avoid actual or potential conflicts of interest relating to the position for which you have been nominated.

Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department of Agriculture's designated agency ethics official and that has been provided to this Committee.

Attachment A
Speaking Engagements 2007-2009

| <i>Date</i> | <i>Org</i> | <i>Location</i> | <i>Details</i> |
|-------------------------|-------------------------------|---------------------------|---|
| June 27 07 | Elk head Reservoir Dedication | Elk head Reservoir | Keynote Speaker |
| July 18 07 | Greenway Foundation | Confluence Park | Dedication |
| Aug. 15 07 | COGA speech | Convention Center | Keynote Speech |
| Aug. 17 07 | Grouse Talk | 719 | Endangered Species speech |
| Sept 25 07 | Douglas County Water Summit | Wildlife Experience | Keynote Lunch Address |
| Sept. 9 07 | Colo Ground Water Conference | Colorado Springs | Keynote Address |
| Nov. 9 07 | Denver Water Authority | Renaissance Denver Hotel | Keynote Speech--Future Water Supply Sources |
| May 17 08 | Colorado Cooperation | Devils Thumb, Tabernash | Colorado's Water Future |
| June 18 08 | Denver Chamber | 1445 Market Street | Water for Colorado's cities and agriculture communities. |
| Oct 23 rd | South Platte Forum | Radisson Longmont | Keynote Luncheon Speaker -Imagining Colorado's Water Future |
| Jan 8 th '09 | Action 22 | Pueblo Marriott | Keynote luncheon Speaker- The Future of Colorado's Water |
| Jan. 29 '09 | CWC | Hyatt Regency Tech Center | The Water Buffalo Stampede speech |

143

Attachment B

Describe fully all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

From September, 2004 until February, 2007 while practicing law at Arnold & Porter, I represented the following entities before the Forest Service and USDA.

1. On behalf of Vail Resorts Management
 - a. Review of the Breckenridge Ski Area Peak 8 lift expansion
 - b. On behalf of Vail Resorts, appeal of the White River Forest Plan
 - c. Submission of comments concerning certain White River Forest Plan revisions.

2. On behalf of CNL Real Estate Investment Trust
 - a. Negotiation with the Forest Service, Booth Creek, and CNL regarding Forest Service reissuance of ski resort permits for resulting from sale of resorts.

3. On behalf of Copper Mountain Ski Resort
 - a. Resolution of third party timber patent claims within the Copper Mountain Ski Area boundaries.
 - b. Resolution of snowmaking proposals accompanying a Copper Mountain master development plan.

From February, 2007 until the present, while serving as Director of the Colorado Department of Natural Resources, I have periodically met with representatives of the Forest Service and USDA on a wide variety of federal/state policy and programmatic issues within the existing jurisdiction of the State and/or the Forest Service. These issues have included:

1. Coordination with the Forest Service on a wide variety of fuel reduction, forest restoration projects, and fire fighting plans and strategies.
2. Coordination on wide-array of Colorado's forest and natural resources issues including work on threatened and endangered species issues within a number of Colorado's national forests.



United States
Office of Government Ethics
1201 New York Avenue, NW, Suite 500
Washington, DC 20005-3917

September 18, 2009

The Honorable Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Harris Sherman, who has been nominated by President Obama for the position of Under Secretary for Natural Resources and Environment, Department of Agriculture. Mr. Sherman also has been nominated for the position of Member of the Board of Directors, Commodity Credit Corporation.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert J. Cusick".

Robert J. Cusick
Director

Enclosures

September 16, 2009

Mr. Raymond J. Sheehan
Designated Agency Ethics Official
U.S. Department of Agriculture
Washington, DC 20250-0122

Dear Mr. Sheehan:

The purpose of this letter is to explain the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Under Secretary for Natural Resources and Environment, U.S. Department of Agriculture (USDA). Holding the position of the Under Secretary for Natural Resources and Environment also entails a membership on the Board of Directors of the Commodity Credit Corporation (CCC). The steps detailed below also take into account any potential conflicts or appearances thereof associated with that CCC position.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to section 208(b)(1), or qualify for a regulatory exemption, pursuant to section 208(b)(2). I further understand that the interests of the following persons are imputed to me: any spouse or minor child of mine, any general partner of a partnership in which I am a limited or general partner, any entity in which I serve as officer, director, trustee, general partner, or employee; and any person or entity with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position as Executive Director, Colorado Department of Natural Resources. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Colorado Department of Natural Resources, is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d). I will continue to participate in the Colorado Public Employees Retirement Association, a defined benefit plan. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of the State of Colorado to provide this contractual benefit to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208 (b)(2), such as 5 C.F.R. § 2640.201(c)(2).

Upon confirmation, I will resign my position as Trustee of the Boettcher Foundation. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Boettcher Foundation, is a party or represents a party unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635 502(d).

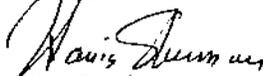
I will remain a non-managing partner in the A&P Realty Associates General Partnership ("A & P"). The partnership is invested in one holding, Plaza on Harvest Hill, LP, a multi-unit apartment building in Dallas, Texas. During my appointment to the position of Under Secretary, I will not provide any services to A&P. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of A&P or Plaza on Harvest Hill, LP, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that, pursuant to 18 U.S.C. § 208(a), the financial interests of each general partner in A&P will be imputed to me during my government service. For the duration of my appointment, I will not participate personally and substantially in any particular matter in which I know that any of these partners has a financial interest, if the particular matter has a direct and predictable effect on that interest, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

As a result of my retirement from Arnold and Porter LLP, I receive monthly retirement income from an unfunded retirement account. My monthly retirement income is based upon the number of years of service with Arnold and Porter LLP. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of Arnold and Porter, LLP, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1).

I will divest all of my interests in the following Morgan Stanley Managed Accounts within 90 days of confirmation: Northern Trust Value Investors; Davis Advisors; Tradewinds Global; and Madison Large Cap Growth. Within each of these accounts are specific assets directly involved with oil and gas exploration, mining and forest management. Specifically, Deere Company; Waste Management, Inc.; BP; Chevron; ConocoPhillips; Devon Gas Services; Exxon Mobil; Occidental Petroleum; Barrick Gold; Baker Hughes and Newmont Mining pose a conflict of interest. Due to the structure of each managed account it is not feasible for me to divest of the specific holdings that pose a conflict of interest and therefore liquidating each managed account is necessary. With regard to each of the specific assets identified above, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of the entity until I have divested it, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Finally I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to commitments I have made in this and any other ethics agreement.

Sincerely,



Harris Sherman

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | |
|---|---|---|---|--|
| Date of Appointment, Candidacy, Election, or Nomination (Month, Day, Year) | Reporting Status (Check appropriate box) <input type="checkbox"/> Incumbent <input type="checkbox"/> New Entrant, Nominee, or Candidate <input type="checkbox"/> Termination <input type="checkbox"/> Filer | Calendar Year Covered by Report | Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting Individual's Name | Last Name SHERMAN | First Name and Middle Initial HARRIS | | Reporting Periods Individuals: The reporting period is the preceding calendar year except Part D of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. |
| Position for Which Filing | Title of Position Under Secretary for Natural Resources & Environment | Department or Agency (If Applicable) U.S. Department of Agriculture | | Termination Filing: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) | Address (Number, Street, City, State, and ZIP Code) CO Dept. of Natl Resources, 1313 Sherman St., Denver, CO 80203 | Telephone No. (Include Area Code) 303-866-3111 Ext. 8670 | | Termination Filing: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | Title of Position(s) and Date(s) Filed | | | |
| Presidential Nominations Subject to Senate Confirmation | Name of Congressional Committee Considering Nomination Committee on Agriculture, Nutrition and Forestry | Do You Intend to Create a Qualified Diversified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | |
| Certification I CERTIFY that the statements I have made on this form and all attached schedules are true, complete and correct to the best of my knowledge. | Signature of Reporting Individual <i>Harris D. Sherman</i> | Date (Month, Day, Year) 7/31/09 | | Nominees, New Entrants and Candidates for President and Vice President. Schedule A—The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. |
| Other Review (If desired by agency) | Signature of Other Reviewer | Date (Month, Day, Year) | | Schedule B— Not applicable. |
| Agency Ethics Official's Opinion On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below) | Signature of Designated Agency Ethics Official (Reviewing Official) <i>A. K. [Signature]</i> | Date (Month, Day, Year) 8/27/09 | | Schedule C— Part I (Individuals)—The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. |
| Office of Government Ethics Use Only | Signature <i>[Signature]</i> | Date (Month, Day, Year) 7/15/09 | | Schedule D— Show all arrangements or arrangements—Show any agreements or arrangements as of the date of filing. |
| Comments of Reviewing Officials (If additional space is required, see the reverse side of this sheet) | | | | Schedule D— The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| (Check box if filing extension granted & indicate number of days) <input type="checkbox"/> | | | | Agency Use Only |
| (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | | DOGE Use Only |
| | | | | SEP 18 2009 |

149

155 of 308

Reporting Individual's Name
 Sharman, Harris

SCHEDULE A

Page Number
 2

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Date (Mo., Day, Yr.) Only if Honoraria | |
|---|---|---------------------|----------------------|-----------------------|-----------------|--------------------|----------------|-----------|---|---------------------------|-------------------|--------------------|----------------------|----------------|-------------------|---|---|
| | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | Over \$250,000* | Over \$500,000,000 | Exempted Trust | IRA | Type | Amount | | | | | | | |
| For you, your spouse, and dependent children, report each asset held for investment or the production of income which had a fair market value exceeding \$1,000 at the close of the reporting period, or which generated more than \$200 in income during the reporting period, together with such income. For yourself, also report the source and actual amount of earned income exceeding \$200 (other than from the U.S. Government). For your spouse, report the source but not the amount of earned income of more than \$1,000 (except report the actual amount of any honoraria over \$200 of your spouse). None <input type="checkbox"/> | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$100,000 | Over \$100,000 | Over \$1,000,000* | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) |
| Examples Central Airlines Common Doe Jones & Smith, Hometown, State Kempstone Equity Fund IRA: Heartland 500 Index Fund | | | X | | | | | X | | | X | | | | | | |
| 1 MORGAN STANLEY ACTIVE ASSETS TAX FREE TRUST (money market fund) | | X | | | | | | | | | | | | | | | |
| 2 DISCOVER FINANCIAL SERVICES COMMON | X | | | | | | | X | | X | | | | | | | |
| 3 MORGAN STANLEY COMMON | | | | | | | | | | X | | | | | | | |
| 4 PIMCO COMM REAL RETURN | | X | | | | | | | | | | | | | | | |
| 5 AMERICAN FUNDS FUNDAMENTAL INVESTORS A | | | | | | | | | | | X | | | | | | |
| 6 UNIT LIMIT MUNI INSD CO 63SPS (municipal bond) | | | | | | | | X | | | X | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.

Prior Filings Cannot be Used

150

156 of 308

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 3

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead |
|--|---|--------------|-------------------|-------------------|--------------------|-----------------|----------------|----------------|---|----------|---------------------------|-------------------|-------------------|--------------------|---------------|---|---|
| | None <input type="checkbox"/> | \$0-\$10,000 | \$10,001-\$25,000 | \$25,001-\$50,000 | \$50,001-\$100,000 | Over \$100,000* | Over \$500,000 | Excepted Trust | Type | | | Amount | | | | | |
| | | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | Over \$10,000 | | |
| 1 FRANKLIN PORTFOLIO ADVISORS MUNICIPAL MANAGED ACCT. MORGAN STANLEY BML ACCT. | | X | | | | | | | X | | | | | | | | |
| 2 DENVER CO CITY & CNTY BRD WTR COMMS WTR BOND DUE 12/1/13 | | | | | | | | | X | | | | | | | | |
| 3 CMC ACADEMIC FACLS LEASING TR CO CTFS PARTN. BOND DUE 8/1/15 | | | | | | | | | X | | | | | | | | |
| 4 BOULDER CNTY CO DEV REV UNIV CORP FOR ATMOSPHERIC RESEARCH BOND DUE 9/1/15 | | | | | | | | | X | | | | | | | | |
| 5 COLORADO SPRINGS CO UTILS REV B BOND DUE 11/15/15 | | | | | | | | | X | | | | | | | | |
| 6 DENVER CO CITY AND CNTY GENL OBLIG DUE 8/1/17 | | | | | | | | | X | | | | | | | | |
| 7 ADAMS 12 FIVE STAR SCHOOLS CO CTFS PARTN BOND DUE 12/1/17 | | | | | | | | | X | | | | | | | | |
| 8 CO. WTR RES PWR DEV AUTH BOND DUE 9/1/18 | | | | | | | | | X | | | | | | | | |
| 9 CASTLE ROCK, CO WTR & SWR ENTERPRISE REVBOND DUE 12/1/19 | | X | | | | | | | X | | | | | | | | |

* This category applies only if the asset/income is jointly that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Print Editions Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **4**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$200)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|--|--|------------------|-------------------------|-----------------------|-----------------------|----------------------|------|---|----------|---------------------------|--------|-------------------|----------------------|----------------|---|--|
| | None | Over \$1,000,000 | \$500,000 - \$1,000,000 | \$250,000 - \$500,000 | \$100,000 - \$250,000 | \$50,000 - \$100,000 | None | Type | | | Amount | | | | | |
| | | | | | | | | Dividends | Interest | None (or less than \$200) | None | \$1,001 - \$1,500 | \$15,001 - \$100,000 | Over \$100,000 | | |
| 1 EL PASO & ELBERT CNTYS CO JT DIST 23-J PEYTONBOND DUE 12/15/17 | | | X | | | | | X | | | | X | | | | |
| 2 W. METRO FIRE PROT N DIST CO BOND DUE 12/15/17 | | | | | | | | X | | | | X | | | | |
| 3 FOOTHILLS PK & REC DIST AUTH CO SCHOOL DIST CTFS BOND DUE 12/1/20 | | | | | | | | X | | | | X | | | | |
| 4 DENVER CO CITY & CNTY SCHOOL DISTRICT NO. 1 BOND DUE 12/1/22 | | | | | | | | X | | | | X | | | | |
| 5 ADAMS BROOMFIELD AND WELD CNTYS CO. LO SCHOOL DIST 27-J BOND DUE 12/1/21 | | | | | | | | X | | | | X | | | | |
| 6 EAGLE, GARFIELD & ROUTT CNTYS CO. SCH. DIST NO. 60J BOND DUE 12/1/24 | | | | | | | | X | | | | X | | | | |
| 7 MORGAN STANLEY/NORTHERN TRUST MANAGED ACCOUNTS | | | | | | | | | X | | | | | | | |
| 8 MORGAN STANLEY MONEY MARKET ACCT | | | | | | | | | X | | | | | | | |
| 9 30% ALCOA, INC | X | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 † Prior Editions Cannot be Used.

SCHEDULE A continued
 (Use only if needed)

Page Number: 5

| BLOCK A Assets and Income | BLOCK D Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | |
|--|---|----------------|----------------------|-----------------------|-------------------------|------------------|------------------|---|----------|---------------------------|-------------------|--------------------|----------------------|-------------------------|------------------|--------------------------------------|---------------|------------------|
| | None <input type="checkbox"/> | \$0 - \$10,000 | \$10,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 | Over \$5,000,000 | Type | | Amount | | | | | | Other Income (Specify Type & Amount) | Date Acquired | |
| | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$10,000 | \$10,001 - \$100,000 | \$100,001 - \$1,000,000 | Over \$1,000,000 | | | Over \$5,000,000 |
| 1 A.L.S.T.A.C.E CORP | | | | | | | | | | X | | | | | | | | |
| 2 AMERICAN EXPRESS CO. ANHEUSER BUSCH CO INC | X | | | | | | | X | | X | | | | | | | | |
| 3 ANALOG DEVICES | X | | | | | | | | | X | | | | | | | | |
| 4 AT&T INC | X | | | | | | | X | | | | X | | | | | | |
| 5 BAKER HUGHES | X | | | | | | | | | X | | | | | | | | |
| 6 BANK OF NEW YORK MELLON CORP | X | | | | | | | | | X | | | | | | | | |
| 7 BLACK AND DECKER CORP | X | | | | | | | | | X | | | | | | | | |
| 8 BLACKROCK INC | X | | | | | | | | | X | | | | | | | | |
| 9 BOEING CO | X | | | | | | | X | | | | X | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent child(ren). If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child(ren), mark the other higher categories of value, as appropriate.
 Prior 2010 Filings Cannot be Used.

Reporting Individual's Name

SHERMAN, HARRIS

SCHEDULE A continued

(Use only if needed)

Page Number

6

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date Acq. / Dis. (Yr.) Only if Required | |
|--|---|----------------|---------------------|---------------------|----------------------|-------------------|-------------------|--|-----------|----------|---------------------------|-------------------|--------------------|---------------------|--|---|---------------|
| | None <input type="checkbox"/> | \$0 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$1,000,000* | Over \$50,000,000 | Exempted Trust | Type | | | Amount | | | | | |
| | | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$50,000 | | | Over \$50,000 |
| 1 BRISTOL MYERS SQUIBB CO | X | | | | | | | | | | X | | | | | | |
| 2 CHEVRON | X | | | | | | | | | | X | | | | | | |
| 3 CHUBB CLEAR CHANNEL COMM | X | | | | | | | X | | X | X | | | | | | |
| 4 COCA COLA CO | X | | | | | | | | | X | | | | | | | |
| 5 DEERE & CO DEUTSCHE TELEKO AG I ORD | X | | | | | | | X | | X | X | | | | | | |
| 6 DOW CHEMICAL CO | X | | | | | | | X | | | | | | | | | |
| 7 ENCANA CORP | X | | | | | | | | | X | | | | | | | |
| 8 ERICSSON LM TEL ADR CL B | X | | | | | | | | | X | | | | | | | |
| 9 EXXON MOBIL CORP | X | | | | | | | | | X | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.

Prior Editions Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **7**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Amount, Annual) | Date (Mo., Day, Yr.) Only if Hourly | | | |
|--|---|-----------------------|-------------------------|---------------------------|----------------------------|-----------------------------|-------------------|-------------------|--|--|---|----------|---------------------------|--------|--|--|--|--|--|--|--|--|--|--|--|
| | | | | | | | | | | | Type | | | | | | | | | | | | | | |
| | | | | | | | | | | | Dividends | Interest | None (or less than \$201) | Amount | | | | | | | | | | | |
| | \$1,001 - \$100,000 | \$100,000 - \$500,000 | \$500,000 - \$1,000,000 | \$1,000,000 - \$5,000,000 | \$5,000,000 - \$10,000,000 | \$10,000,000 - \$25,000,000 | Over \$25,000,000 | Exception: Trusts | | | | | | | | | | | | | | | | | |
| 1 GAP INC | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 2 GENERAL ELECTRIC CO. | | | | | | | | | | | | | | X | | | | | | | | | | | |
| 3 GOLDMAN SACHS GRP INC H&R BLOCK | | | | | | | | | | | | | | X | | | | | | | | | | | |
| 4 HARTFORD FIN SERS GRP INC HERSHEY | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 5 HOME DEPOT INC | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 6 HUDSON CITY BANCORP INC | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 7 INTEL CORP | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 8 INTERNATIONAL BUSINESS MACHINES INC | X | | | | | | | | | | | | | X | | | | | | | | | | | |
| 9 JOHNSON & JOHNSON | X | | | | | | | | | | | | | X | | | | | | | | | | | |

* This category applies only if the asset-income is solely that of the filer's spouse or dependent children. If the asset-income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

161 of 308

Reporting Individual's Name: **SHERMAN, HARRIS** SCHEDULE A continued Page Number: **B**
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead | | |
|--|---|------------------|----------------|----------------|---------------|---------------|--------------|---|----------|----------|---------------|------------------|------------------|----------------|---|---|----------------|---------------|
| | None <input type="checkbox"/> | Over \$1,000,000 | Over \$500,000 | Over \$100,000 | Over \$50,000 | Over \$10,000 | Over \$1,000 | None (or less than \$201) | Interest | Dividend | Escaped Trust | Amount | | | | | | |
| | | | | | | | | | | | | Over \$5,000,000 | Over \$1,000,000 | Over \$500,000 | | | Over \$100,000 | Over \$50,000 |
| 1 KRAFT FOODS INC CL A | X | | | | | | | | | | | | | | | | | |
| 2 LOCKHEED MARTIN CORP | X | | | | | | | | | | | | | | | | | |
| 3 MCGRAW HILL COS INC | X | | | | | | | | | | | | | | | | | |
| 4 MEDTRONIC METLIFE | X | | | | | | | | | | | | | | | | | |
| 5 MICROSOFT CORP | X | | | | | | | | | | | | | | | | | |
| 6 NEW YORK COMMUNITY BAN/CORP NIT DOCOMO INC SP ADR | X | | | | | | | X | | | | | | | | | | |
| 7 OMNICOM GROUP PENNY JC | X | | | | | | | | | | | | | | | | | |
| 8 PEPSICO | X | | | | | | | | | | | | | | | | | |
| 9 PFIZER INC | X | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **9**

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$200" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Hierarchic |
|---------------------------------------|---|-------------------|-------------------------|-----------------------|-----------------------|----------------------|-----------------------------|--|----------|--------------------------|-------------------|-------------------|--------------------|---------------------|--------------------|------------------|--|---|--|
| | BLOCK A | Over \$1,000,000* | \$500,001 - \$1,000,000 | \$250,001 - \$500,000 | \$100,001 - \$250,000 | \$50,001 - \$100,000 | None for less than \$50,000 | Type | | Amount | | | | | | | | | |
| | | | | | | | | Dividends | Interest | None for less than \$200 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | Over \$25,000.000* | Over \$5,000,000 | | | |
| 1 PHILIP MORRIS INTL INC | X | | | | | | | X | | | | | | | | | | | |
| 2 PROCTER AND GAMBLE | X | | | | | | | | | X | | | | | | | | | |
| 3 SANOFI-AVENTIS ADS | X | | | | | | | X | | | | | | | | | | | |
| 4 SCHLUMBERGER LTD | X | | | | | | | | | X | | | | | | | | | |
| 5 SUNOCO INC UNITED PARCEL SERVICE | X | | | | | | | X | | X | | | | | | | | | |
| 6 VERIZON COMMUNICATIONS | X | | | | | | | X | | X | | | | | | | | | |
| 7 WALMART STORES INC | | | | | | | | | | | X | | | | | | | | |
| 8 WELLS FARGO & CO | X | | | | | | | X | | | | | | | | | | | |
| 9 WYETH | | | | | | | | X | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the upper right categories of value, as appropriate.
 *Prior Ex-Rates Cannot be Used.

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | | | | | | |
|---|--|----------------------|----------------------|-----------------------|-------------------------|------------------|--------------------------|-------------------|-------------------|----------------|---|-------------|--|-------------------|-----------------------|----------------|------------------|---|------------------|--|--|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | 10 | | | | | | | | | |
| Assets and Income | Valuation of Assets as close of reporting period | | | | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | Date (Mo., Day, Yr.) Only if Homocare | | | | | | | | |
| | BLOCK B | | | | | | | | | | BLOCK C | | | | | | | | | | |
| BLOCK A | None <input type="checkbox"/> | \$1,001 - \$150,000 | \$50,001 - \$100,000 | \$250,001 - \$500,000 | \$750,001 - \$1,000,000 | Over \$1,000,000 | None for less than \$201 | Over \$20,000,000 | Over \$50,000,000 | Excepted Trust | Type | | Amount | | | | | Other Income (Specify Type & Actual Amount) | | | |
| | | | | | | | | | | | Dividends | Interest | None for less than \$201 | \$201 - \$100,000 | \$100,001 - \$500,000 | Over \$500,000 | Over \$1,000,000 | | Over \$5,000,000 | | |
| 1 MORGAN STANLEY DAVIS ADVISORS MANAGED ACCT. | | | | | | | | | | | | X | | | | | | | | | |
| 2 MORGAN STANLEY MONEY MARKET ACCT. | | | | | | | | | | | | X | | | | | | | | | |
| 3 AGILENT TECHNOLOGIES | | X | | | | | | | | | X | | | | | | | | | | |
| ALTRIA GROUP INC | | | | | | | | | | | X | | | | | | | | | | |
| AMERICAN EXPRESS | | | | | | | | | | | X | | | | | | | | | | |
| 4 AMERIFRISE FINANCIAL INC | | X | | | | | | | | | X | | | | | | | | | | |
| ADN CORP | | | | | | | | | | | X | | | | | | | | | | |
| 5 BANK OF NEW YORK MELLON | | X | | | | | | | | | | | X | | | | | | | | |
| 6 BECTON DICKSON & CO | | X | | | | | | | | | | | X | | | | | | | | |
| 7 BED, BATH AND BEYOND | | X | | | | | | | | | | | X | | | | | | | | |
| 8 BERKSHIRE HATHAWAY B | | X | | | | | | | | | | | | X | | | | | | | |
| CANADIAN NATURAL RESOURCES LTD | | X | | | | | | | | | | | X | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Price Edits may be used.

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)*" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | |
|--|---|--------------------|---------------------|----------------------|-----------------------|-------------------|------------------|--|-----------|----------|---------------------------|-------------------|--------------------|---------------------|---|--|---------------|
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | Over \$1,000,000* | Over \$5,000,000 | Type | | | Amount | | | | | | |
| | | | | | | | | Category Trust | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$50,000 | | | Over \$50,000 |
| 1 CARDINAL HEALTHCARE INC | | X | | | | | | X | | | | | | | | | |
| 2 DISCO SYSTEM | | X | | | | | | | | | | | | | | | |
| 3 COMCAST CORP CL A | | X | | | | | | | | | | | | | | | |
| 4 CONOCOPHILLIPS COSTCO WHOLESALE CORP COVIDEN LTD | | | | | | | | X X X | | | | | | | | | |
| 5 CVS WHOLESALE CORP | | | | | | | | | | | | | | | | | |
| 6 DEVON ENERGY CORP | | | | | | | | | | | | | | | | | |
| 7 DIAGEO PLC SPON ADR | | X | | | | | | X | | | | | | | | | |
| 8 DUN & BRADSTREET CP | | X | | | | | | | | | | | | | | | |
| 9 EOG RESOURCES INC | | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 12

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | |
|---------------------------------|---|---------------------|----------------------|-----------------------|-----------------------|-------------------|----------------------------|-------------------|--|-----------|----------|--------------------------|-------------------|-------------------|--------------------|---|--|----------------------|-------------------|
| | BLOCK B | | | | | | | | BLOCK C | | | | | | | | | | |
| | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$1,000,000* | \$5,000,001 - \$10,000,000 | Over \$50,000,000 | Emergent Trust | Dividends | Interest | None for less than \$201 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$15,000 | | | \$15,001 - \$100,000 | Over \$1,000,000* |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | |
| 1 EXPRESS SCRIPTS INC | X | | | | | | | | | | | X | | | | | | | |
| 2 GOOGLE INC | X | | | | | | | | | | | X | | | | | | | |
| 3 GRUPO TELEVISIA SA GLOBAL DEP | X | | | | | | | | X | | | | | | | | | | |
| 4 H&R BLOCK | X | | | | | | | | | | | X | | | | | | | |
| 5 HARLEY DAVIDSON INC | X | | | | | | | | | | | X | | | | | | | |
| 6 HEWLETT PACKARD | X | | | | | | | | | | | X | | | | | | | |
| 7 IRON MOUNTAIN INC | X | | | | | | | | | | | X | | | | | | | |
| 8 JOHNSON & JOHNSON | X | | | | | | | | | | | X | | | | | | | |
| 9 JP MORGAN CHASE AND CO COMMON | X | | | | | | | | | | | X | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Fair Editions Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **13**

SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Historical | |
|--------------------------------|---|----------------------|---------------------|---------------------|-------------------|----------------------------|-------------------|---|-----------|----------|---------------------------|---------------|-------------------|-------------------|--------------------|----------------------|-------------------|---|--|------------------|
| | | | | | | | | Type | | | | | | | | | | | | |
| | \$100,001 - \$500,000 | \$50,001 - \$100,000 | \$25,001 - \$50,000 | \$10,001 - \$25,000 | Over \$1,000,000* | \$5,000,001 - \$25,000,000 | Over \$50,000,000 | Excepted Trust | Dividends | Interest | None (or less than \$201) | \$1 - \$1,000 | \$1,001 - \$1,500 | \$1,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$100,000 | Over \$1,000,000* | | | Over \$5,000,000 |
| Name: <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | |
| 1 LOEWS CORP | X | | | | | | | X | | | | | | | | | | | | |
| 2 MERCK & CO | X | | | | | | | | | | X | | | | | | | | | |
| 3 MICROSOFT | X | | | | | | | | | | X | | | | | | | | | |
| 4 MCDYS CORP | X | | | | | | | X | | | | | | | | | | | | |
| 5 NEWS CORP LTD/CL A | X | | | | | | | | | | X | | | | | | | | | |
| 6 OCCIDENTAL PETROLEUM CORP | | | | | | | | X | | | | | | | | | | | | |
| 7 PFIZER INC | X | | | | | | | | | | X | | | | | | | | | |
| 8 PHILIP MORRIS INTL INC | X | | | | | | | X | | | | | | | | | | | | |
| 9 PROCTER AND GAMBLE | X | | | | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Please Refer to Column 13 of Form 278e

167 of 308

| Reporting individual's Name SHERMAN, HARRIS | | SCHEDULE A continued (Use only if needed) | | | | | | | | | | Page Number 14 | | | |
|--|---|--|-------------------|-------------------|-------------------|-------------------|-------------------|---|----------|--------------------------|-------------------|--------------------|--------------------|----------------|---|
| Assets and income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | |
| | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | Dividends | Interest | None for less than \$201 | \$1,001 - \$7,500 | \$7,501 - \$15,000 | \$15,001 - 100,000 | Over \$100,000 | Other Income (Specify Type & Actual Amount) |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | |
| 1 PROGRESSIVE CORP OHIO | X | | | | | | | | X | | | | | | |
| 2 SCHERING PLOUGH CORP | X | | | | | | | | X | | | | | | |
| 3 SEALED AIR CP | X | | | | | | | | X | | | | | | |
| 4 TEXAS INSTRUMENTS | X | | | | | | | | X | | | | | | |
| 5 TRANSATLANTIC HOLDINGS INC | X | | | | | | | | X | | | | | | |
| 6 TRANSOCEAN LTD | X | | | | | | | | X | | | | | | |
| 7 TYCO INTERNATIONAL LTD | X | | | | | | | X | | X | | | | | |
| 8 UNITED HEALTH GROUP INC | X | | | | | | | | X | | | | | | |
| 9 VULCAN MATERIALS CO WALMART STORES | X | | | | | | | X | | X | X | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.
 Power Bottom Cannot be Used.

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at close of reporting period | | | | | | | BLOCK C | | | | | | | | | | Other Income (Specify Type & Amount) | Date (Mo., Day, Yr.) Only if Honoraria |
|-------------------------------|--|---------------------|----------------------|--------------------|----------------------------|-----------------------|-----------------|-----------|----------|---------------------------|-------------------|-------------------|--------------------|---------------------|------------------|------------------|--|--------------------------------------|---|
| | BLOCK B | | | | | | | Type | | Amount | | | | | | | | | |
| | \$1,000 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | Over \$1,000,000 * | \$5,000,001 - \$10,000,000 | Over \$50,000,000,000 | Keeneport Trust | Dividends | Interest | None (or less than \$200) | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$50,000 | Over \$1,000,000 | Over \$5,000,000 | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | |
| 1 | WELLS FARGO & CO | | | | | | | X | | | | | | | | | | | |
| 2 | MORGAN STANLEY TRADEWINDS GLOBAL MANAGED ACCT | | | | | | | | X | | | | | | | | | | |
| 3 | MORGAN STANLEY MM ACCT | | | | | | | | X | | | | | | | | | | |
| 4 | AEGON NV ADR | X | | | | | | X | | | | | | | | | | | |
| 5 | ALCANTARA ADR | X | | | | | | | | X | | | | | | | | | |
| 6 | ALUMINA LTD | X | | | | | | X | | | | | | | | | | | |
| 7 | ANGLOGOLD ASHANTILIMITED | | | | | | | X | | X | | | | | | | | | |
| 8 | ASTRAZENZA | | | | | | | X | | | | | | | | | | | |
| 9 | BARRICK GOLD CORP | | | | | | | X | | | | | | X | | | | | |
| 10 | BP PLC ADS | | | | | | | X | | | | | | | | | | | |
| 11 | CAMECO CORP | X | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent child. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Prior editions cannot be used.

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | Page Number | | | | | | |
|-----------------------------|--|----------------------|-----------------------|-----------------------|-------------------|------------------|-------------------|---|-----------|----------|--------------------------|-------------------|--------------------|---------------------|-------------------|------------------|---|----------------------|------------------|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | | 17 | | | | | | |
| Assets and Income | Valuation of Assets at close of reporting period | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | |
| | BLOCK B | | | | | | | BLOCK C | | | | | | | | | | | |
| BLOCK A | None for less than \$1,001 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$1,000,000* | Over \$5,000,000 | Over \$25,000,000 | None for less than \$201 | Dividends | Interest | None for less than \$201 | \$1,001 - \$7,500 | \$7,501 - \$15,000 | \$15,001 - \$50,000 | Over \$1,000,000* | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) | Only if Homeless |
| 1 | | X | | | | | | | | | X | | | | | | | | |
| 2 | | X | | | | | | | X | | X | | | | | | | | |
| 3 | | X | | | | | | | | | X | | | | | | | | |
| 4 | | X | | | | | | | | | X | | | | | | | | |
| 5 | | X | | | | | | | | | | | X | | | | | | |
| 6 | | X | | | | | | | | | X | | | | | | | | |
| 7 | | X | | | | | | | | | X | X | | | | | | | |
| 8 | | X | | | | | | | | | X | | | | | | | | |
| 9 | | X | | | | | | | X | | | | | | | | | | |

* This category applies only if the asset income is solely that of the filer's spouse or dependent children. If the asset income is either that of the filer or jointly held by the filer with the spouse or dependent children, the other higher categories of value, as appropriate, must be used.

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 16

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|--------------------------------|---|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|--|----------|---------------------------|-----------------|-------------------|-------------------|---------------------|-----------------------|-----------------|------------------|--|---|
| | | | | | | | | Type | | Amount | | | | | | | | | |
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Dividends | Interest | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$100,000 | \$100,001 - \$500,000 | Over \$500,000* | Over \$5,000,000 | | |
| 1 NIKEN INC | | X | | | | | | X | | | | | | | | | | | |
| 2 NIPPON TELEGRAPH & TELEPHONE | | X | | | | | | X | | | | | | | | | | | |
| 3 NOKIA CP ADR | | X | | | | | | X | | | | | | | | | | | |
| 4 NOVARTIS AS ADR | | | | | | | | X | | | | | | | | | | | |
| 5 PANASONIC CORP SPON ADR | | X | | | | | | | | X | | | | | | | | | |
| 6 ROHM CO LTD UNSPONS ADR | | X | | | | | | | | | | | | | | | | | |
| 7 ROYAL DUTCH SHELL PLC | | | | | | | | X | | | | | | | | | | | |
| 8 SANOFI AVENTIS ADR | | | | | | | | | | X | | | | | | | | | |
| 9 SEGA SAMMY HDGS SPONS ADR | | X | | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name
 SHEKMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | |
|---|--|--------------------|----------------------|-------------------------|---------------------------|----------------------------|-------------------|---|----------|---------------------------|-------------------|-------------------|--------------------|---------------------|---|--|---------------------|---------------|
| | None <input type="checkbox"/> | \$1,001 - \$10,000 | \$10,001 - \$100,000 | \$100,001 - \$1,000,000 | \$1,000,001 - \$5,000,000 | \$5,000,001 - \$25,000,000 | Over \$25,000,000 | Dividends | Interest | None (or less than \$201) | Amount | | | | | | | |
| | | | | | | | | | | | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | | | \$25,001 - \$50,000 | Over \$50,000 |
| 1. SEKISUI HOUSE LTD ADR | X | | | | | | | | | X | | | | | | | | |
| 2. SEVEN & T HOLDINGS CL LTD ADR | | | | | | | | | | X | | | | | | | | |
| 3. SHISEIDO LTD SON ADR | X | | | | | | | | | X | | | | | | | | |
| 4. SIEMENS AKTIENGES ZLLSHAF | X | | | | | | | X | | | | | | | | | | |
| 5. SK TELECOM CO LTD | | | | | | | | X | | | | | | | | | | |
| 6. SOCIETE GENERALE SP ADR STATOCHYDRO ADR | X | | | | | | | | | | X | | | | | | | |
| 7. STORA ENSO SP ADR SER | X | | | | | | | | | X | | | | | | | | |
| 8. SUMITOMO TR&BK CO | X | | | | | | | | | X | | | | | | | | |
| 9. SUNCOR ENERGY INC | X | | | | | | | X | | | X | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Price Quotes Cannot Be Used

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 20

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Holds | | | | | | |
|--|---|---------------|--------------------|---------------------|----------------------|----------------|----------------|--|----------|----------|------|--------------|---------------------------|-----------------|-------------------|--------------------|---------------------|--|--|---------------|----------------|----------------|--|--|--|
| | None | Under \$1,000 | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$500,000 | None (or less than \$201) | Dividend | Interest | Rent | Capital Gain | None (or less than \$201) | \$201 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$15,000 | \$15,001 - \$50,000 | | | Over \$50,000 | Over \$100,000 | Over \$500,000 | | | |
| 1 SWISSCOM AG ADR | | | | | | | | X | | | | | | | | | | | | | | | | | |
| 2 TDK CP ADR | | | | | | | | | | | | | X | | | | | | | | | | | | |
| 3 TECHNIP-CORLEXIP | | X | | | | | | | | | | | | | | | | | | | | | | | |
| 4 TELECOM ITALIA SPA NEW SHGS SHARES | | | X | | | | | X | | | | | | | | | | | | | | | | | |
| 5 TOMKINS PLC ADS | | X | | | | | | | | | | | X | | | | | | | | | | | | |
| 6 TOPPAN PRTG LTD ADR TOTAL FINA ELF SA | | X | | | | | | | | | | | X | | | | | | | | | | | | |
| 7 UBS AG | | X | | | | | | | | | | | X | | | | | | | | | | | | |
| 8 UNITED UTILITIES GROUP UPM KYMMENE CORP ADR | | X | | | | | | X | | | | | X | | | | | | | | | | | | |
| 9 VODAFONE GP PLC ADS | | X | | | | | | X | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 † Prior Editions Cannot be Used.

Reporting Individual Name: **SHERMAN, HARRIS** Page Number: **21**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at Close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$2011" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | |
|--|--|--------------------------|-----------------------------|------------------------------|-------------------------------|-------------------------------|-------------------|--|-----------|---------------------------|--|--|--|---------|--|--|--|---|--|--|
| | None <input type="checkbox"/> | \$100,001 - \$25,000,000 | \$25,000,001 - \$50,000,000 | \$50,000,001 - \$100,000,000 | \$100,000,001 - \$250,000,000 | \$250,000,001 - \$500,000,000 | Over \$1,000,000* | Kept/Spouse Trust | BLOCK C | | | | | BLOCK C | | | | | | |
| | | | | | | | | | Type | Amount | | | | | | | | | | |
| 1 WACOAL CP ADR | X | | | | | | | X | Dividends | | | | | | | | | | | |
| 2 WOLTERS KLUWER NV SHON ADR | X | | | | | | | | | | | | | | | | | | | |
| 3 MORGAN STANLEYMADISON LARGE CAP GROWTH MANAGED ACCT. | | | | | | | | | | | | | | | | | | | | |
| 4 MORGAN STANLEY MONEY MARKET ACCT 3M CO | | | | | | | | | X | Interest | | | | | | | | | | |
| 5 ABB LTD | X | | | | | | | | | | | | | | | | | | | |
| 6 APLAG INCORPORATED | | | | | | | | | X | None (or less than \$101) | | | | | | | | | | |
| 7 APACHE CORP | X | | | | | | | | | | | | | | | | | | | |
| 8 BAXTER INTL INC | | | | | | | | | | | | | | | | | | | | |
| 9 BERKSHIRE HATHAWAY B | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the filer higher categories of value, as appropriate.
 Filer Elections Cannot be Used

175 of 308

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 22

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homonium | |
|--|---|---------------------|----------------------|-----------------------|-------------------------|--------------------|--------------|--|----------|---------------------------|-------------------|--------------------|---------------------|----------------------|--|---|--|
| | | | | | | | | BLOCK C | | | | | | | | | |
| | | | | | | | | Type | Amount | | | | | | | | |
| | \$1 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 * | Keoghs/Trust | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$500,000 | |
| 1 CHECK POINT SOFTWARE TECH | X | | | | | | | | | X | | | | | | | |
| 2 GSCO SYS INC | | | | | | | | | | | | | | | | | |
| 3 COCA COLA CO | X | | | | | | | X | | | X | | | | | | |
| 4 COMCAST CORP CL A | X | | | | | | | | | | | | | | | | |
| 5 COSTCO WHOLESALE CORP | X | | | | | | | | | X | | | | | | | |
| 6 COVANCE INC | | | | | | | | | | | | | | | | | |
| 7 DENTSPLY INTERNATIONAL | X | | | | | | | | | X | | | | | | | |
| 8 DEVON ENERGY CORP | X | | | | | | | | | X | | | | | | | |
| 9 DIAGEO SPON ADR DONALDSON CO. INC | | | | | | | | X | | | X | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Entries Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **24**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income, type and amount. If "None for less than \$201" is checked, an other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Interest | |
|---|---|------------------|-------------------------|-----------------------|-----------------------|----------------------|--------------------------|--|----------|--------------------------|-------------------|-------------------------|------------------|--|---|--|--|
| | None <input type="checkbox"/> | Over \$1,000,000 | \$500,001 - \$1,000,000 | \$250,001 - \$500,000 | \$100,001 - \$250,000 | \$50,001 - \$100,000 | None for less than \$201 | Type | | | | | | | | | |
| | | | | | | | | Dividends | Interest | None for less than \$201 | \$201 - \$100,000 | \$100,001 - \$1,000,000 | Over \$1,000,000 | | | | |
| 1 NOVARTIS AG ADR PEPSICO PHARMACEUTICAL PROO ADR | | | | | | | X | | | | | | | | | | |
| 2 QUEST DIAGNOSTICS INC | | | | | | | X | | | | | | | | | | |
| 3 SCHLUMBERGER LTD | | | | | | | | | | | X | | | | | | |
| 4 STAPLES INC | | | | | | | | | | | X | | | | | | |
| 5 STATE STREET CORP SYNOVUS FINANCIAL | | | | | | | | | | | X | | | | | | |
| 6 TARGET CORP | | | | | | | | | | | X | | | | | | |
| 7 WALGREEN CO | | | | | | | | | | | X | | | | | | |
| 8 WALT DISNEY CO | | | | | | | | | | | X | | | | | | |
| 9 WASTE MANAGEMENT INC | | | | | | | | | | | X | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.
 Prior Filings Cannot Be Used

Reporting Individual's Name

SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number

25

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Date 26a. Day, 1c. / Only if Honorary | | |
|--|---|----------|---------------------------|-------------------|-------------------|--------------------|---------------|---|----------|---------------------------|-------------------|-------------------|--------------------|---------------|---|------------------|---|
| | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | Over \$10,000 | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | Over \$10,000 | | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) |
| | | | | | | | | | | | | | | | | | |
| 1 WELLS FARGO & CO YAHOO INC | | | X | | | | | | | | | | | | | | |
| 2 ZIMMER HLDGS INC | | | | | | | | | | | | | | | | | |
| 3 MORGAN STANLEY IRA HOLDINGS MORGAN STANLEY MONEY MARKET ACCT | | | X | | | | | | | | | | X | | | | |
| 4 AMERICAN FUND, FUNDAMENTAL INVESTOR FUND | | | | X | | | | | | | | | | | | | |
| 5 AMERICAN FUND, GROWTH FUND OF AMERICA | | | | X | | | | | | | | | | | | | |
| 6 AMERICAN FUND WASHINGTON MUTUAL FUND | | | | | X | | | | | | | | | | | | |
| 7 PNR 2003-77 DA (Fannie Mae) | | | X | | | | | | | | | | | | | | |
| 8 BLACKROCK INFLATION PROT BOND C | | | | X | | | | | | | | | | | | | |
| 9 PIMCO COMM REAL REY STRAT C | | | | | | | | | | | | | X | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.

Price Editor's Caution: Do Not Use

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | Page Number | | | | | | | | |
|-----------------------------|--|----------------------|-----------------|-------------------|------------------|-----------|-----------------|-------------------|------------------|----------------|------|--|-------------|---------------------------|----------|--|----------------|----------------|------------------|---|--|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | | 26 | | | | | | | | |
| Assets and Income | Valuation of Assets at close of reporting period | | | | | | | | | | | Income: type and amount. If "None for less than \$2011" is checked, no other entry is needed in Block C for that item. | | | | Date (Mo., Day, Yr.) Only if Historic | | | | | |
| | BLOCK A | BLOCK B | | | | | | | | | | | BLOCK C | | | | | | | | |
| | None | 0-100,000 | 100,000-500,000 | 500,000-1,000,000 | Over \$1,000,000 | 0-100,000 | 100,000-500,000 | 500,000-1,000,000 | Over \$1,000,000 | Exempted Trust | None | Dividends | Interest | None for less than \$2011 | 0-25,000 | 25,000-50,000 | 50,000-100,000 | Over \$100,000 | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | |
| 1 | <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | X | | | X | | | | | | |
| 3 | | X | | | | | | | | | X | | | X | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | INCOME 08/\$186,564 09/\$113,272 | |
| 5 | | | | | | | | | | | | | | | | | X | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | \$350.00 PER MONTH UPON RETIREMENT | |
| 7 | | | | | | | | | | | | | | | | | | | | SALARY 08/143,016 09/\$85,190 | |
| 8 | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Print (do not) Cancel to Used.

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

| | | | | | | | | | | | | | | | | | | | | | | | | | | |
|--|--|-------------------|--|--|--|--------------------------|--|--|--|--|--|--|---|--|----------------------------|--|---------------------------|--|--|--|--|--|--|--|--|--|
| Reporting Individual's Name SHERMAN, HARRIS | | SCHEDULE B | | | | Page Number 27 | | | | | | | | | | | | | | | | | | | | |
| Part I: Transactions | | | | | | | | | | | | | None <input type="checkbox"/> | | | | | | | | | | | | | |
| Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE. | | | | | | | | | | | | | Transaction Type (x) Purchase Sale Exchange | | Date (Mo, Day, Yr.) | | Amount of Transaction (x) | | | | | | | | | |
| Identification of Asset | | | | | | | | | | | | | \$1,001 - \$15,000 \$15,001 - \$50,000 \$50,001 - \$100,000 \$100,001 - \$250,000 \$250,001 - \$500,000 \$500,001 - \$1,000,000 \$1,000,001 - \$2,500,000 \$2,500,001 - \$5,000,000 \$5,000,001 - \$10,000,000 Over | | Certificate of Divestiture | | | | | | | | | | | |
| Example: Central Airlines Common | | | | | | | | | | | | | x | | 2/1999 | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| * This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate. | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Part II: Gifts, Reimbursements, and Travel Expenses | | | | | | | | | | | | | None <input type="checkbox"/> | | | | | | | | | | | | | |
| For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by | | | | | | | | | | | | | the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of awareness gifts to determine the total value from one source, exclude items worth \$114 or less. See instructions for other exclusions. | | | | | | | | | | | | | |
| Source (Name and Address) | | | | | | | | | | | | | Brief Description | | Value | | | | | | | | | | | |
| Example: Nat'l Assn. of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | | | | | | | | | | | | | Airfare ticket, hotel room & meals incident to national conference 6/15/99 (personal activity unrelated to duty) | | \$500 | | | | | | | | | | | |
| | | | | | | | | | | | | | Leather briefcase (personal friend) | | \$300 | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | | | | | |

Prior Editions Cannot Be Used.

175

181 of 308

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name SHERMAN, HARRIS | SCHEDULE D | Page Number 29 |
|---|-------------------|--------------------------|

Part I: Positions Held Outside U.S. Government

Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or

consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|---|----------------------------------|------------------------------|-----------------|-----------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 5/92 2/83 | Present 1/00 |
| 1 | ARNOLD AND PORTER LLP | LAW FIRM | PARTNER | 05/80 | 01/07 |
| 2 | STATE OF COLORADO, DEPT. OF NATURAL RESOURCES | STATE AGENCY | EXECUTIVE DIRECTOR | 02/07 | PRESENT |
| 3 | BOETTCHER FOUNDATION | NON-PROFIT COMMUNITY FOUNDATION | TRUSTEE | 04/02 | PRESENT |
| 4 | A&P REALTY ASSOCIATES GENERAL PARTNERSHIP | GENERAL PARTNERSHIP | NON-MANAGING GENERAL PARTNER | 1982 | PRESENT |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source

Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any

corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential Candidate or Presidential Candidate

None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|--|---|
| Examples: | Doe Jones & Smith, Hometown, State Mega University (client of Doe Jones & Smith), Hometown, State | Legal services Legal services in connection with university construction |
| 1 | STATE OF COLORADO | EXECUTIVE DIRECTOR, DEPARTMENT OF NATURAL RESOURCES |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used

177

183 of 308

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).

Jill Elaine (Maycumber-maiden) Sommers

2. Date and place of birth.

(b)(6)

Fort Scott, Kansas

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).

Married to Michael J. Sommers – Policy Director for Republican Leader John Boehner, US Capitol

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

University of Oregon 1987-1988

University of Kansas 1988-1991

**Bachelor of Arts Degree awarded December of 2005
(Course work completed in 1991)**

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

Office of Senator Robert J. Dole (R-KS)

Intern - January 1991-May 1991 - Washington DC

Receptionist – May 1991-August 1992 - Washington DC

Regional Representative – August 1992-November 1994

Pittsburg, Kansas/Topeka, Kansas

Represented the Senator at various functions and assisted constituents with various requests and issues regarding the federal government.

Assistant to the Administrative Assistant - Washington DC

November 1994-August 1995

Assisted the AA in managing a staff of 25 legislative assistants and correspondents

Clark & Muldoon, P.C. - August 1995-February 1998
Legislative Assistant
Assisted two attorneys with agricultural related client business as well as general office management.

Taggart & Associates - March 1998-August 1998
Senior Associate
Principal contact for clients with legislative concerns on issues such as agriculture, health care, and telecommunications

Chicago Mercantile Exchange
Manager, Legislative and Regulatory Affairs – August 1998-January 2001
Associate Director, Government Affairs – January 2001-March 2004
Primarily responsible for monitoring regulatory matters pending before the federal government. Accompanied Members of Congress, Administration officials and congressional staff to Chicago as part of the CME educational visitation program.

International Swaps and Derivatives Association
August 2005 – August 2006
Policy Director and Head of US Government Affairs
Principal contact in Washington DC for ISDA member firms on a variety of over-the-counter derivatives issues.

Commodity Futures Trading Commission
August 2007-Present
Commissioner

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.

None

7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.

Office of Senator Robert J. Dole 1991-1995
CFTC – appointed 2007-present

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None

8. **Political Affiliation:** The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Republican

9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

**Kansas Society of Washington DC - Treasurer
University of Kansas Alumni Association – Washington DC contact**

10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

The following speeches can be found on the CFTC website:

September 2, 2009

Statement of Commissioner Jill Sommers, Joint Meetings on Harmonization of Regulation

July 29, 2009

Statement by Commissioner Jill Sommers, Commodity Futures Trading Commission

July 28, 2009

Statement by Commissioner Jill Sommers, Commodity Futures Trading Commission

June 9, 2009

Speech by Commissioner Jill E. Sommers, The U.S. Regulatory Landscape: The View from Washington, FIA/FOA International Derivatives Expo, London

September 19, 2008

Remarks by Commissioner Jill E. Sommers, "Integrity of the Futures Markets and the Role of Transparency", Asia Derivatives Conference, Tokyo, Japan

July 29, 2008

Opening Statement Commissioner Jill Sommers Before CFTC Agricultural Advisory Committee, Commodity Futures Trading Commission Headquarters

July 15, 2008

Statement Commissioner Jill Sommers Regarding Global Markets Advisory Committee, Commodity Futures Trading Commission Headquarters

June 10, 2008

Remarks of Commissioner Jill Sommers Before the Energy Markets Advisory Committee, Commodity Futures Trading Commission Headquarters

April 22, 2008

Statement of Commissioner Jill Sommers, Agricultural Markets Roundtable, Commodity Futures Trading Commission Headquarters

March 11, 2008

Statement of Commissioner Jill Sommers Regarding the CFTC-SEC Memorandum of Understanding, U.S. Securities and Exchange Commission Headquarters

November 13, 2007

Remarks by Commissioner Jill Sommers Before the Futures Industry Association Law and Compliance Division and the New York City Bar Association, Futures Industry Association Law and Compliance Division and the New York City Bar Association

October 16, 2007

Speech by Commissioner Jill Sommers before the Futures Industry Association, Law and Compliance Luncheon, Futures Industry Association, Law and Compliance Luncheon

September 18, 2007

Remarks by Commissioner Jill Sommers on Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets, Commodity Futures Trading Commission Headquarters

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes

2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None

3. Have you ever received a government guaranteed student loan? If so, has it been repaid?

Yes – all loans have been repaid in full

4. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No

5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No

6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No

7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.

1998-2004 The Chicago Mercantile Exchange – futures regulation, CEA Reauthorization

**2005-2006 International Swaps and Derivatives Association –
OTC derivatives issues, OTC energy swaps. CEA Reauthorization.**

8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

If any conflicts are found, I will divest my interest

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.

Currently, no conflicts have been identified



United States
Office of Government Ethics
1201 New York Avenue, N.W., Suite 500
Washington, DC 20005-3917

July 27, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Jill E. Sommers, who has been nominated by President Obama for the position of Commissioner of the Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

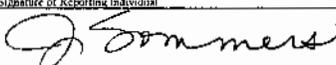
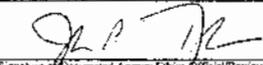
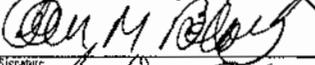
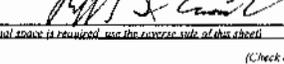
Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosure

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | |
|--|--|---|---|--|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate boxes) <input type="checkbox"/> Incumbent <input type="checkbox"/> New Entrant, Nominee, or Candidate <input checked="" type="checkbox"/> Termination Filer | Calendar Year Covered by Report <input checked="" type="checkbox"/> New Entrant, Nominee, or Candidate <input type="checkbox"/> Termination Filer | Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting Individual's Name Last Name: Summers First Name and Middle Initial: Jill E. | Title of Position Commissioner | Department or Agency (If Applicable) Commodity Futures Trading Commission | Termination Date (If Applicable) | Reporting Periods Incumbents: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) Address (Number, Street, City, State, and ZIP Code): 1155 21st Street, NW Washington DC 20581 Telephone No. (include Area Code): 202 418-6030 | Position(s) Held with the Federal Government During the Preceding 12 Months (if Not Same as Above) Title of Position(s) and Date(s) Held: CFTC Commissioner since 08/09/07 | Presidential Nominee Subject to Senate Confirmation Name of Congressional Committee Considered: Senate Agriculture Committee Do You Intend to Create a Qualified Divorced Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | Termination Date (If Applicable) | Nominees, New Entrants and Candidates for President and Vice President: Schedule A—The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. Schedule B—Not applicable. Schedule C, Part I (Inhibitors)—The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. Schedule C, Part II (Arrangements)—Show any arrangements or arrangements as of the date of filing. Schedule D—The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| CERTIFICATION I CERTIFY that the statements I have made on this form and all attached schedules are true, complete and correct to the best of my knowledge. | | Signature of Reporting Individual  | Date (Month, Day, Year) 7/21/09 | Agency Use Only |
| Other Review (if desired by agency) | | Signature of Other Reviewer  | Date (Month, Day, Year) 07/21/2009 | Agency Use Only |
| Agency Ethics Official's Opinion On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below). | | Signature of Designated Agency Ethics Official/Reviewing Official  | Date (Month, Day, Year) 7-21-09 | Agency Use Only |
| Office of Government Ethics Use Only | | Signature  | Date (Month, Day, Year) 7/27/09 | Agency Use Only |
| Comments of Newsprint Officials (If additional space is required, use the reverse side of this sheet) (Check box if filing extension granted & indicate number of days _____) <input type="checkbox"/> | | | | Agency Use Only |
| (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | | Agency Use Only |
| Supersedes Prior Editions, Which Cannot Be Used | | | | Agency Use Only |

185

191 of 308

JUL 21 2009

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | | | |
|--|--|-----------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---|----------------------|----------------|--------|--|--|
| Sommers, Jill E. | | (Use only if needed) | | | | | | | | | | 3 | | | | | | |
| BLOCK A | Valuation of Assets at close of reporting period | BLOCK B | | | | | | | | | | BLOCK C | | Date (Mo., Day, Yr.) | Order of Merit | | | |
| | | None (or less than \$1,000) | \$1,001 - \$1,999 | \$2,000 - \$4,999 | \$5,000 - \$9,999 | \$10,000 - \$24,999 | \$25,000 - \$49,999 | \$50,000 - \$99,999 | \$100,000 - \$249,999 | \$250,000 - \$499,999 | \$500,000 - \$999,999 | Over \$1,000,000 | Income Type | | | Amount | | |
| Income: (type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item.) | | | | | | | | | | | | | Other Income (Specify Type & Annual Amount) | | | | | |
| Type | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | None (or less than \$201) | | | | | | |
| 1 | JiLegg Mason Large Cap Growth Fund | X | | | | | | | | | | | | | | | | |
| 2 | Starbucks | X | | | | | | | | | | | | | | | | |
| 3 | Coca Cola Co | X | | | | | | | | | | | | | | | | |
| 4 | JP Morgan Chase | X | | | | | | | | | | | | | | | | |
| 5 | General Electric Co. | X | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | |
| 9 | Dreyfus Primmer Strategic Value Fund | X | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 † Prior Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | | Page Number | | | | | | |
|-----------------------------|--|--|---------------|-------------------|--------------------|---------------------------|----------------------|-----------------------|-----------------------|--------------------|---------------------|--|----------------------|---|--------------------|------------------|-------------------|---|-------------------|---|
| Sommers, Jill E | | (Use only if needed) | | | | | | | | | | | | 4 | | | | | | |
| BLOCK A | Assets and Income | BLOCK B | | | | | | | | | | BLOCK C | | Date (Mo., Day, Yr.) Only if Homeowner | | | | | | |
| | | Valuation of Assets at close of reporting period | | | | | | | | | | Income: type and amount. If "None for less than \$20 (1)" is checked, no other entry is needed in Block C for that item. | | | | | | | | |
| | | None (enter dash) | Under \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$25,000,000 | Over \$50,000,000 | Over \$100,000,000 | Over \$500,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$25,000,000 | Other Income (Specify Type & Actual Amount) |
| | | Type | Dividends | Interest | Capital Gains | None (for less than \$20) | \$201 - \$1,000 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$25,000,000 | Other Income (Specify Type & Actual Amount) | | |
| 1 | Legg Mason Partners Aggressive Growth Fund | X | | | | | | | | | | | | | | | | | | |
| 2 | Legg Mason Partners Large Cap Growth Fund | X | | | | | | | | | | | | | | | | | | |
| 3 | Lord Abbett Affiliated Fund | X | | | | | | | | | | | | | | | | | | |
| 4 | Morgan Stanley S&P Index Fund | X | | | | | | | | | | | | | | | | | | |
| 5 | Templeton Growth Fund | X | | | | | | | | | | | | | | | | | | |
| 6 | Meiri Lynch & Co. Medium Term Note | X | | | | | | | | | | | | | | | | | | |
| 7 | San Bernardino Co. CA Financial Authority Pension Obligation | X | | | | | | | | | | | | | | | | | | |
| 8 | Harriburg PA Redeem Author Rev | X | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

| | | |
|---|-------------------|------------------|
| Reporting Individual's Name Summers, Jiff E. | SCHEDULE D | Page Number 7 |
|---|-------------------|------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|---------------------------------------|----------------------|---------------|-----------------|---------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6-92 | Present |
| | Doe Jones & Smith, Hometown, State | Law firm | Partner | 7-89 | 1-00 |
| 1 | | | | | |
| 2 | | | | | |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential Candidate or Presidential Candidate
 None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|---|---|
| Examples: | Doe Jones & Smith, Hometown, State | Legal services |
| | Mega University (client of Doe Jones & Smith), Moneytown, State | Legal services in connection with university construction |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).
Kenneth Albert Spearman
2. Date and place of birth.
(b)(6) East Chicago, Indiana
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).
Married to Maria Spearman (Hunyh Mo Khanh). Maria is a Personal Trainer who is self-employed and works out of our home at (b)(6)
(b)(6)
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.
-Governors State University, 9/1975 to 8/1978, Masters in Business Administration, 8/1978 (was working for Arthur Andersen & Co. while attending graduate school).
-Indiana University, 9/1970 to 8/1973, Bachelors of Science, 8/1973.
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.
 - 2006-present **AgFirst Farm Credit Bank - Appointed Director**
Serves as an appointed director on the board of AgFirst Farm Credit currently a member of the Governance Committee.
 - 2003-2006 **Lake Wales Medical Center - Board Member**
 - 1991-2007 **CITRUS WORLD, INC. - Director, Internal Audit**
Responsible for the design and implementation of annual plans for reviewing and appraising the soundness, adequacy, and application of accounting, financial, and other operating internal controls.
 - 1980-1991 **CITRUS CENTRAL, INC. - Controller, General Accounting**
Responsible for the financial management of reporting function for \$100+ million company with a staff of four accountants. Cash management, receivables, payables, payroll, credit, insurance, general ledger, financial statement preparation, budgets, treasury function, annual audit coordination are examples of areas within my purview.
 - 1976-1980 **JAMES WILLIAMS & CO. - Co-founder, Certified Public Accountants Firm**
Responsible for planning, directing and monitoring financial, compliance and operational audits for a wide variety of clients in both the private and public sectors. Managed financial and treasury/controllership functions performed by seven staff and senior accountants.

- 1973-1976 **ARTHUR ANDERSEN & CO.** - Audit Staff, Small Business Division
 Performed independent audit examinations at both the staff and project-lead levels, for clients in the manufacturing, hotel and not-for-profit sectors. Functions included audits, preparation of special reports, costs analysis, purchase investigations and tax preparation. Evaluations of internal controls and suggesting improvements along with drafting financial statements and disclosure footnotes were also performed.
6. **Military Service:** Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.
Yes, from 06/1962 until 10/1965. I served in the US Army Intelligence Service attaining the rank of Specialist Fifth Class. My service number was 167 39 568 and I received an Honorable Discharge.
7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.
None.
8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.
Board of Directors resolution recognition from Citrus World, Inc. for faithful and dedicated service...2007, and the Award of Excellence from National Society of Accountants for Cooperatives...2003, and also received an award from Lake Wales Medical Center for servicing as Board Chairman....2005.
9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.
Institute of Internal Auditors, National Society of Accountants for Cooperatives, Florida Farm Bureau.
10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry, agricultural credit, or other matters within the jurisdiction of this Committee or the Farm Credit Administration.

Membership articles written and published in the National Society of Accountants for Cooperatives newsletter (News and Views) while serving as the groups National President (listed below). The articles published were of an administrative, motivational and strategic planning nature written quarterly during my one year term. Please see attached a copy of each quarterly newsletter with my message on

front page. The list below is a complete listing of all my published writings.

- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Fall 2002).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Winter 2002).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Spring 2003).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Summer 2003).

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?
Under the terms of my ethics agreement, I will resign from my current employer upon confirmation by the Senate.
2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.
Florida's Natural Growers, a division of Citrus World, Inc. \$123,500, one third of which to be received over the next three years. AgFirst Farm Credit Bank, \$34,000, one fourth of which to be received over the following four years after separation.
3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)
No.
4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in federal commodity income and price support programs? (If yes, provide all details including amounts of government payments and loans received or forfeited by crop and farm, et cetera during the past five years.)
No.
5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any current or previously existing agency of the Department of Agriculture, including through any of the farm or rural development lending programs? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)
No.
6. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from, involving, or handled by any current or previously existing institution regulated or overseen by the Farm Credit Administration? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)
No.
7. Have you, or any partnership or closely held corporation in which you have an interest, received payments for crop losses from the federal crop insurance program in the past 5

years? (If yes, give details.)

No.

8. Have you ever received a government guaranteed student loan? If so, has it been repaid?
Yes and they were repaid in full over 30 years ago.
9. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)
No.
10. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)
No.
11. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)
No.
12. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Farm Credit Administration, or before Congress involving matters within the jurisdiction of this Committee, the Department of Agriculture, or the Farm Credit Administration.
None.
13. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.
Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Farm Credit Administration's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.
14. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.
Upon confirmation to the FCA Board, I will resign from my position on the board of directors of the AgFirst Farm Credit Bank (AgFirst). I will also sign the Ethics Pledge required by the Obama administration.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

July 23, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Kenneth A. Spearman, who has been nominated by President Obama for the position of Board Member of the Farm Credit Administration.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

Robert J. Cusick
Director

Enclosures

ETHICS AGREEMENT

July 21, 2009

Wendy R. Laguarda
Designated Agency Ethics Official & Assistant General Counsel
Office of General Counsel
FARM CREDIT ADMINISTRATION
1501 Farm Credit Drive
McLean, VA 22102-5090
(703) 883-4234

Dear Ms. Laguarda:

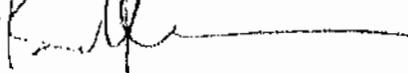
The purpose of this letter is to describe the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Board Member of the Farm Credit Administration.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that the interests of the following persons are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position on the board of directors of the AgFirst Farm Credit Bank (AgFirst). For one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which AgFirst is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d). In addition, I will cash out my deferred savings plan (Savings Plan) with AgFirst within 90 days of my confirmation.

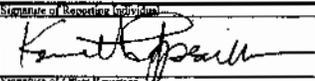
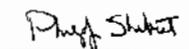
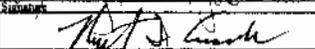
Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,



Kenneth A. Spearman

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| U.S. Office of Government Ethics | | Reporting Individual's Name | | Position for Which Filing | | Location of Present Office (or forwarding address) | | Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | | Termination Date (If Applicable) (Month, Day, Year) | | Fee for Late Filing | |
|---|--|--|--|--|--|--|--|---|--|---|--|--|--|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | | Reporting Individual's Name | | Position for Which Filing | | Location of Present Office (or forwarding address) | | Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | | Termination Date (If Applicable) (Month, Day, Year) | | Fee for Late Filing | |
| Reportable Status (Check appropriate box) <input type="checkbox"/> Incumbent <input checked="" type="checkbox"/> New Entrant, Nominee, or Candidate <input type="checkbox"/> Termination Filer | | Last Name Spearman | | First Name and Middle Initial Kenneth A | | Address (Number, Street, City, State and ZIP Code) Farm Credit Administration -- 1501 Farm Credit Drive, McLean, VA 22102 | | Telephone No. (Include Area Code) (703) 883-4020 | | Reporting Periods The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filer's year up to the date you file. Part II of Schedule D is not applicable. | | Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. | |
| Presidential Nominations Subject to Senate Confirmation Name of Congressional Committee Considering Nomination Agriculture, Nutrition and Forestry | | Do You Intend to Create a Qualified Disqualified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | Certification I CERTIFY that the statements I have made on this form and all attached schedules are true, complete and correct to the best of my knowledge. | | Signature of Reporting Individual  | | Date (Month, Day, Year) 6/29/2009 | | Termination Filing: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. | | Nominations, New Entrants and Candidates for President and Vice President: | |
| Other Review (If desired by filer) Signature of Other Reviewer  | | Signature of Designated Agency Ethics Officer/Reviewing Official  | | Date (Month, Day, Year) 7/2/09 | | Date (Month, Day, Year) 7/2/09 | | Schedule A and the reporting period for income (BLOCKS C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. | | Schedule B: Not applicable. | | Schedule C: Part II (if applicable). The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. | |
| Office of Government Ethics Use Only Signature  | | Date (Month, Day, Year) 7/23/09 | | Schedule C: Part I (if applicable). The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. | | Schedule D: The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. | | Agency Use Only | | OGE Use Only JUL 16 2009 | | Schedule E: Not applicable. | |
| Comments of Reviewing Officials (If additional space is required, use the reverse side of this sheet) | | | | | | | | | | | | (Check box if filing extension granted & indicate number of days _____) <input type="checkbox"/> | |
| (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | | | | | | | | | | | |

200

206 of 308

| Reporting Individual's Name | | SCHEDULE A | | | | | | | | | | | | Page Number | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|---|------------|--|--|--|--|--|--|--|--|--|--------|---|--|--|--|--|--|--|--|--|--|--|---|---|---|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|
| Kenneth A. Spearman | | | | | | | | | | | | | | 2 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | Type | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | Amount | | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honoraria | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| For you, your spouse, and dependent children, report each asset held for investment or the production of income which had a fair market value exceeding \$1,000 at the close of the reporting period, or which generated more than \$200 in income during the reporting period, together with such income. For yourself, also report the source and actual amount of earned income exceeding \$200 (other than from the U.S. Government). For your spouse, report the source but not the amount of earned income of more than \$1,000 (except report the actual amount of any honoraria over \$200 of your spouse). None <input type="checkbox"/> | | | | | | | | | | | | | | None (or less than \$1,001) \$1,001 - \$15,000 \$15,001 - \$50,000 \$50,001 - \$100,000 \$100,001 - \$250,000 \$250,001 - \$500,000 \$500,001 - \$1,000,000 Over \$1,000,000 * \$1,000,001 - \$5,000,000 \$5,000,001 - \$10,000,000 \$10,000,001 - \$50,000,000 Over \$50,000,000 | | | | | | | | | | | | Excepted Investment Fund Excluded Trust Qualified Trust Dividends Rent and Royalties Interest Capital Gains None (or less than \$201) \$201 - \$1,000 \$1,001 - \$5,000 \$5,001 - \$10,000 \$10,001 - \$25,000 \$25,001 - \$50,000 \$50,001 - \$100,000 \$100,001 - \$250,000 \$250,001 - \$500,000 \$500,001 - \$1,000,000 Over \$1,000,000 | | | | | | | | | | | | | | | | | | | | | | | | | |
| Examples: <ul style="list-style-type: none"> Common Stocks U.S. Gov't Bonds Municipal Bonds Foreign Bonds Real Estate Private Equity Funds IRA: Vanguard 500 Index Fund | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | IRA: Amer Bal Fund (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | IRA: Amer Mutual FD Inc (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | IRA: Amer Europacific Growth Fd (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | IRA: GoldmanSachs Growth Opps FD (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | IRA: Amer Growth Fund of America (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | IRA: Invest Co America (Wachovia Securities) | | | | | | | | | | | | X | | | | | | | | | | | | | | | | | | | | | | | | | |
| * This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate. Prior Filings Cannot be Used. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

201

207 of 308

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: **Kenneth A. Spearman** Page Number: **11**

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| | Identification of Assets | Transaction Type (s) | | | Date (Mo., Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | | | |
|---|----------------------------------|----------------------|------|----------|----------------------|---------------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|---------------------------|---------------------------|----------------------------|-----------------------------|-------------------|----------------------------|--|
| | | Purchase | Sale | Exchange | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$2,000,000 | \$2,000,001 - \$5,000,000 | \$5,000,001 - \$25,000,000 | \$25,000,001 - \$50,000,000 | Over \$50,000,000 | Certificate of Divestiture | |
| 1 | Example: Central Airlines Common | x | | | 2/1/99 | | | | x | | | | | | | | | |
| 2 | N/A | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| | Source (Name and Address) | Brief Description | Value |
|---|---|--|----------------|
| | Examples: Natl Assn. of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room & meals incident to national conference 6/1/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$100 |
| 1 | N/A | | |
| 2 | | | |
| 3 | | | |
| 4 | | | |
| 5 | | | |

Prior Editions Cannot Be Used

210

216 of 308

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name Kenneth A. Spearman | SCHEDULE C | Page Number 12 |
|---|-------------------|--------------------------|

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out, loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None

Category of Amount or Value (x)

| Creditor (Name and Address) | Type of Liability | Date Incurred | Interest Rate | Term of applic- cable | Category of Amount or Value (x) | | | | | | | | | | | | | | | | |
|--|--|---------------|---------------|--------------------------|---------------------------------|------------------|------------------|-------------------|---------------------|------|------|------|------|------|------|--|--|--|--|--|--|
| | | | | | \$10,001-\$100,000 | 100,001-\$50,000 | 50,001-\$100,000 | 100,001-\$500,000 | 500,001-\$1,000,000 | Over | None | None | None | None | None | | | | | | |
| Examples: First District Bank, Washington, DC John Jones, 123 J St., Washington, DC | Mortgage on rental property, Delaware Promissory note | 1991 1999 | 8% 10% | 25 yrs. on demand | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g. 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits

None

| Status and Terms of any Agreement or Arrangement | Parties | Date |
|--|------------------------------------|-------|
| Example: Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/00. | Doe Jones & Smith, Hometown, State | 7/85 |
| 1 Deferred Compensation Plan | Florida Natural Growers | 12/91 |
| 2 Defined Benefit Plan | Citrus Central | 10/80 |
| 3 Deferred Savings Plan | AgFirst Farm Credit Bank | 01/06 |
| 4 | | |
| 5 | | |
| 6 | | |

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name Kenneth A. Spearman | SCHEDULE D | Page Number 13 |
|---|-------------------|--------------------------|

Part I: Positions Held Outside U.S. Government

Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or

consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political affiliations and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|---|----------------------------------|----------------------------|-----------------|-----------------|
| Examples: | Nat'l Assn. of Rock Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 6/92 7/85 | Present 1/00 |
| 1 | AgFirst Farm Credit Bank, 1401 Hampton Street, Columbia, South Carolina 29202 | Bank | Board Director | 01/2006 | Present |
| 2 | Florida's Natural Growers, 20205 US Hwy 27, Lake Wales, Florida 33853 | Citrus Marketer and Processor | Director of Internal Audit | 12/1991 | 12/2007 |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source

Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any

corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate

None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|---|---|
| Examples: | Doe Jones & Smith, Hometown, State Metro University (client of Doe Jones & Smith), Hometown, State | Legal services Legal services in connection with university construction |
| 1 | AgFirst Farm Credit Bank, 1401 Hampton street, Columbia, South Carolina 29202 | Board Director |
| 2 | Florida Natural Growers, 20205 US Hwy 27, Lake Wales, Florida 33853 | Director of Internal Audit |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Print Editions Cannot Be Used.

JEFF BINGAMAN
NEW MEXICO

703 HART SENATE OFFICE BUILDING
WASHINGTON, DC 20510-3152
(202) 224-1521
IN NEW MEXICO: (505) 463-6008
TDD: (202) 224-1182
Senator: Bingaman@bingaman.senate.gov

United States Senate

September 24, 2009

The Honorable Blanche Lincoln
Chairman
Senate Agriculture, Nutrition and Forestry Committee
Washington, D.C. 20510

Dear Chairman Lincoln:

I am writing to support President Obama's nomination of Scott O'Malia to be a Commissioner on the Commodity Futures Trading Commission, and to encourage the Agriculture Committee to move quickly to approve his nomination.

Scott served on the Energy and Natural Resources Committee in 2003 before moving to the Appropriations Committee. Scott's primary responsibilities on the committee were oil and natural gas issues. He demonstrated a deep understanding of these issues and of the importance energy markets have on our economy. During his tenure on the Committee, Scott was always willing to cooperate with my staff in the development of hearings and legislation.

Since joining the Energy and Water Development Subcommittee on Appropriations, Scott has continued to work with the Energy and Natural Resources Committee to implement the 2005 and 2007 authorizing statutes. He has been willing to listen and develop constructive solutions to complex energy policy problems. A good example of his commitment to improving our nation's investment in a balanced energy strategy has been his effort to expand the role of the Department of Energy's laboratories in the areas of alternative energy and climate modeling. Scott understands the importance of diversifying our energy generation mix, and the critical role our national labs play in this effort.

In addition to Scott's work on both the authorizing and appropriations committees, I also believe his private sector experience (electric generation) provides him with the experience and knowledge that will benefit the Commodity Futures Trading Commission.

For these reasons, I fully support Scott O'Malia's nomination to serve the Commodities Futures Trading Commission.

Sincerely,



Jeff Bingaman
United States Senator

ALBUQUERQUE
(505) 348-6207

SARASOTA
(888) 376-5209

LAS CRUCES
(575) 523-8963

ROSEMBO
(505) 622-7113

SANTA FE
(505) 588-1647

United States Senate
 SENATE OFFICE OF CLERKS

September 22, 2009

The Honorable Blanche Lincoln
 Chairman
 Senate Agriculture, Nutrition and Forestry Committee
 535A Russell Building
 Washington, DC 20540

Dear Chairman Lincoln:

I am writing to support Scott O'Malia for Commissioner of the Commodity Futures Trading Commission. President Obama nominated Scott earlier this month. I encourage the Agriculture Committee to move quickly to approve this nomination so that the Commission will be fully staffed as it deliberates reforms to the financial and commodities industry.

Since becoming Chairman of the Energy and Water Subcommittee in December 2006, I have worked with Scott O'Malia. Scott has exhibited an in-depth knowledge of energy issues and has worked hard to implement policies that will transform our nation's energy sector. As an example, Scott has been a tireless advocate for improving the effectiveness of the loan guarantee program to ensure that the nation invests its resources in a balanced energy strategy and deploys low-emission technology as quickly as possible and on a scale that make a significant and lasting difference.

Scott works in a bipartisan and constructive manner, advocating strongly for his Member's position, but willing to find common ground in order to complete the work before the subcommittee. I believe his experience on both the authorizing and appropriations committees, and his role in the private sector provide him with the expertise and knowledge that will benefit the Commodity Futures Trading Commission and expand the Commission's depth on energy issues.

I appreciate your taking on this new role at the Commission. And thanks for taking a look at this nomination.

Sincerely,

 Byron Dorgan

PATTY MURRAY
WASHINGTON

COMMITTEES
APPROPRIATIONS
BUDGET
HEALTH, EDUCATION
AND PENSIONS
RULES AND ADMINISTRATION
VETERANS AFFAIRS

United States Senate
WASHINGTON, DC 20510-4704

September 29, 2009

The Honorable Blanche Lincoln
Chairman
Committee on Agriculture, Nutrition
and Forestry
Russell Senate Office Building 328A
Washington, D.C. 20510

The Honorable Saxby Chambliss
Ranking Member
Committee on Agriculture, Nutrition
and Forestry
Russell Senate Office Building 328A
Washington, D.C. 20510

Dear Chairman Lincoln and Ranking Member Chambliss:

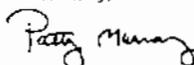
I write to express my strong support for the nomination of Scott O'Malia to be a Commissioner on the Commodity Futures Trading Commission (CFTC).

Mr. O'Malia has worked well with me and my staff as Minority Clerk to the Appropriations Committee's Energy and Water Subcommittee, of which I am a member. During his tenure on the Appropriations Committee, he served as both Majority and Minority staff. In both capacities, I found him to be straightforward and fair as he worked with me on my priorities over the past five years. I have great confidence that he would bring the same professional and forthright demeanor to the CFTC as a Commissioner.

Mr. O'Malia has legislative and private sector experience related to the energy sector that will be needed on the CFTC as it works to address financial and commodity reform. He has enjoyed good bipartisan working relationships and is someone Senators and Members of Congress should expect to work with effectively in the future if he is confirmed. I urge you to quickly and carefully consider this nomination so that the full complement of Commissioners can be in place as the CFTC undertakes its important role in addressing financial and commodity sector reform.

I am confident that Mr. O'Malia's confirmation as a Commissioner will help the CFTC address pressing regulatory needs. I hope you will give his nomination all due consideration.

Sincerely,


Patty Murray
United States Senator

112 RUSSELL SENATE OFFICE BUILDING
WASHINGTON, DC 20510-4704
(202) 224-2821

1811 L STREET AVENUE, NE
SUITE 318
BELLEVUE, WA 98004-3046
(425) 462-4950

2920 WESTHEDGE AVENUE, NW
SUITE 302
EVERETT, WA 98201-4107
(425) 253-0515

2888 JACOBSON FEDERAL BUILDING
510 2ND AVENUE
SEATTLE, WA 98174-1623
(206) 453-4345
Toll Free: (866) 481-9186

501 WEST MAIN AVENUE
SUITE 802
SPokane, WA 99201-0513
(509) 674-9519

810 PULLER
SUITE 111
TACOMA, WA 98402
(253) 572-1177

THE MURRAY CENTER
1325 OLYMPIA ROAD
VANCOUVER, WA 98061-3856
(360) 586-7797

website: <http://www.patty.gov>
e-mail: p.murray@senate.gov
#PattyMurrayCFTCFooter

401 S. ...
...
386-415-7111



September 29, 2009

The Honorable Blanche Lincoln, Chairman
Senate Committee on Agriculture, Nutrition and Forestry
328A Senate Russell Building
Washington, DC 20510

Dear Senator Lincoln,

I am writing to urge you to support the nomination of the Honorable Harris Sherman who has been nominated for the Under Secretary of Natural Resources and the Environment. I have known Mr. Sherman for over twenty years on both a personal and professional level and can attest to his unique qualifications as a special individual, one having a thorough understanding and respect for the environment and an individual who can help guide the long term management and protection of our natural resources.

Mr. Sherman's experience in the caring management of people and his breadth of experience as a well respected public servant will lend itself well in the position that he is being nominated to fill. Mr. Sherman has the ability to manage and guide policy for our forests and to protect wildlife and water quality on the lands that he will be overseeing. In addition he is well versed in the laws governing the USFS and the unique balance that the agency faces for the multi-use of its resources.

It is interesting times that we face as we seek to better understand how to protect our natural resources for future generations. I believe that Mr. Sherman has the commitment, experience and the depth of knowledge to be a fair and generous protector of our natural resources and encourage you to support his nomination. He is a good and honest person that can seek consensus, solve problems and help establish policies that further protect our environment. We wish you well in the upcoming proceedings and hope that you will support his nomination.

Yours truly,

A handwritten signature in black ink, appearing to read "Timothy H. Beck", written over a horizontal line.

Timothy H. Beck
Executive Vice President, Planning



10/04/2009 1:51

209-634-3300

Frederick.P.Certano



October 2, 2009

The Honorable Blanche Lincoln
 Chairman
 Senate Committee on Agriculture, Nutrition & Forestry
 328A Senate Russell Building
 Washington, DC 20510

Senator Lincoln:

Brundage Mountain Resort is located on the Payette national Forest in west central Idaho. Agriculture and tourism are the largest industries in Idaho, a state rich in natural resources. We are strongly in support of appointing Harris Sherman to the position of USDA Under Secretary for Environment and Natural Resources. Mr. Sherman has the experience with the agriculture, recreation, forest industries and the states directly affected by them to be an outstanding Under Secretary for Environment and Natural Resources. He has the back ground to provide unique insight on the effect of Washington decisions on states dependent on natural resources and the knowledge to craft decisions that will benefit all stake holders.

Thank you for your consideration!

Sincerely;

Frederick P. Certano
 President/GM
 Brundage Mountain Resort
 President
 Idaho Ski Areas Association

Brundage Mountain Company • P.O. Box 1063 • McCall, Idaho 83638
 208.634.4151 • fax 208.634.2806 • 1.800.888.7544
 www.brundage.com • info@brundage.com

Hon. Blanche Lincoln
Hon. Saxby Chambliss
United States Senate

Dear Chairman Lincoln and Ranking Member Chambliss:

I write you today to voice support for the nomination of Mr. Harris Sherman to the position of Under Secretary of Agriculture for Natural Resources and Environment.

Mr. Sherman's reputation for pragmatism and earnest collaboration is well-earned. Throughout his tenure as the Executive Director of the Colorado Department of Natural Resources, he has shown a calm commitment to building consensus and honoring stakeholder processes.

On contentious issues ranging from the regulation of oil and gas development to the designation of roadless areas in Colorado's National Forests, Mr. Sherman has maintained a voice of reason and a sincere willingness to hear all sides and strive for compromise, often amidst a cacophony of opposition from the extreme areas of the ideological spectrum. While his service has been of immense value to the people of Colorado and the environment, the compromises he has crafted have not always pleased everyone. But the results are impressive.

Mr. Sherman's accomplishments include a balanced regulatory regime that, for the first time, injects environmental protection and public health as factors in the consideration of oil and gas drilling permit applications and the culmination of a locally-driven stakeholder process to designate appropriate areas in national forests as off-limits to road building.

I fully expect Mr. Sherman's professionalism, experience and acumen will serve the President and the nation well. We will be sorry to see him leave Colorado, but will take solace in the fact that his public service will continue.

Very truly yours,



Dan Grossman
Rocky Mountain Regional Director
Environmental Defense Fund



PO Box 2308 • 249 Warren Ave • Silverthorne, CO 80498 • 970-468-0295 • Fax 970-488-1208 • www.nwccog.co.us

- MEMBER JURISDICTIONS**
- City of Glenwood Springs
- City of Steamboat Springs
- Town of Carbondale
- EAGLE COUNTY**
Avon
Basalt
Eagle
Gypsum
Minturn
Red Cliff
Vail
- GRAND COUNTY**
Fraser
Granby
Grand Lake
Hot Sulphur Springs
Kremmling
Winter Park
- JACKSON COUNTY**
Walden
- PITKIN COUNTY**
Aspen
- SUMMIT COUNTY**
Breckenridge
Dillon
Frisco
Montezuma
Silverthorne

September 29, 2009

United States Senate Agriculture, Nutrition and Forestry Committee
 Senator Harkin, Chair
 Senator Chambliss, Ranking Republican Member

Dear Senators Harkin, Chambliss and Committee Members,

Northwest Colorado Council of Governments is a voluntary association of twenty-eight county and municipal governments in the High Country of Colorado. Nearly seventy percent of the ten thousand square mile region covered by the NWCCOG member jurisdictions is owned by the people of the United States and managed by a variety of federal agencies, principal of which is the USDA Forest Service. The NWCCOG Region is also the headwaters of the Colorado and North Platte River Systems, supplying domestic, agricultural and recreational water to vast areas of the Great Plains and Southwest.

In matters pertaining to the management of national forest system lands and water quality and quantity, we have worked with Harris Sherman in his position as Executive Director of the Colorado Department of Natural Resources. In our experience, we have found Director Sherman to be not only a proponent, but an active participant in collaborative conservation. He has demonstrated his ability to participate in good faith in collaborative processes with a diverse array of stakeholders. Those processes are often long, tedious, and arduous as a wide variety of opinions are explored, but they are nonetheless necessary to achieve quality and lasting decisions regarding our forest and water resources in an open, neighborly and democratic manner indicative of the Rocky Mountain West.

We consider Harris Sherman to be a good partner in the difficult job of managing public resources and encourage you to confirm him as USDA Undersecretary for Natural Resources and Environment.

Sincerely,

Gary Severson, Executive Director

NATIONAL
SKI AREAS
ASSOCIATION



September 23, 2009

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture, Nutrition & Forestry
328A Senate Russell Building
Washington, DC 20510
Fax: 202 228 2125

**Re: Harris Sherman for USDA Undersecretary
of Environment and Natural Resources**

Dear Senator Lincoln:

I am writing on behalf of the National Ski Areas Association (NSAA) in support of Harris Sherman for the position of USDA Under Secretary for Environment and Natural Resources. NSAA is the trade group for ski areas across the country. Our resort members account for 95% of the skier/snowboarder visits in the United States. One hundred and thirty-four (134) member resorts operate on National Forest System lands.

Harris Sherman's entire career has been dedicated to environment and natural resources issues. As a result of his experience directing the Colorado Department of Natural Resources, he has a great appreciation for working cooperatively with stakeholders to solve problems. His advocacy experience as an attorney will serve him well in representing the Department before Congress. Harris' communication, political and people skills are unmatched in the pool of candidates that have been considered for this post. On a personal level, Harris is one of the most likeable and personable individuals you could ever meet.

Harris Sherman will be a great asset to the Secretary of Agriculture and would provide tremendous leadership for the Administration on environment and natural resources issues. Thank you for your consideration of NSAA's comments.

Best Regards,

A handwritten signature in black ink, appearing to read 'Michael Berry'.

Michael Berry
President

September 29, 2009

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture
328-A Russell
Washington, DC 20510

The Honorable Saxby Chambliss
Ranking Member
Senate Committee on Agriculture
328-A Russell
Washington, DC 20510

Dear Chairman Lincoln and Ranking Member Chambliss:

The Society of American Foresters represents 14,000 foresters, men and women who care deeply for our Nation's vast forest resources. As a professional association, we work closely with the U.S. Department of Agriculture (USDA) to implement conservation programs, state and private forest programs and manage the National Forests. We are writing you in support of the nomination of Harris Sherman to become the Undersecretary for Natural Resources and the Environment (NRE) at USDA.

The Undersecretary for NRE is a key position for overseeing the conservation programs of the Natural Resource Conservation Service (NRCS) and the U.S. Forest Service (USFS). Mr. Sherman's background in forestry, conservation and natural resource protection will serve him well to lead USDA's conservation and forestry division. We appreciate his record of success in implementing conservation strategies, finding common ground, and his commitment and passion for the wise use of natural resources, specifically his support for forest management.

We respectfully urge you to approve Mr. Sherman's nomination and thank you for your consideration.

Sincerely,



Michael T. Goergen, Jr.
Executive Vice President and CEO



September 18, 2009

Via Fax: 202.228.2125

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture, Nutrition & Forestry
328 A Senate Russell Building
Washington, DC 20510

Re: Confirmation of Nomination of Harris Sherman as USDA Under Secretary for Environment and Natural Resources

Chairman Blanche Lincoln:

As a long time member of the National Ski Areas Association, the Steamboat Ski & Resort Corporation is pleased to read that Harris Sherman has been nominated to be the USDA Under Secretary for Environment and Natural Resources. We congratulate Mr. Sherman on his nomination.

During his many years at Arnold & Porter, LLC, one of the top law firms in the country, Harris dealt with numerous public lands issues and always demonstrated professionalism, dedication and focus.

He has worked diligently to improve conservation of open space, wilderness areas, water supplies and forest planning, has a wealth of knowledge with extensive work in the ski industry. He has championed efforts for development of the Colorado Roadless Rule and has dedicated much of his professional career to protecting Colorado's precious natural resources. We are confident that he will serve our nation with the same regard.

We urge the Senate Agriculture Committee to confirm Harris Sherman as this nation's next Under Secretary for Environment and Natural Resources.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "C. Diamond".

Christopher S. Diamond
President and COO

DCB: Geraldine Link

I and the members of the Colorado Timber Industry Association have had a good working relationship with Harris Sherman. He has been very thoughtful and constructive on issues including Roadless Rule, bark beetle epidemics, and national forest timber sale programs. I believe Harris is well-suited and well-qualified for Under Secretary for NRE.

Jon Troxel
ix Director
Colorado Timber Industry Assn
Sent from my Verizon Wireless BlackBerry

VAIL RESORTS®

EXTRAORDINARY RESORTS • EXCEPTIONAL EXPERIENCES™

September 16, 2009

The Honorable Michael Bennet
702 Hart Senate Office Building
Washington, DC 20510

Dear Senator Bennet:

I am writing to support the nomination of Harris Sherman for USDA Under Secretary for Environment and Natural Resources. I would like to strongly encourage you as a member of the Senate Committee on Agriculture, Nutrition and Forestry to vote to confirm Mr. Sherman for this appointment. As one of the largest ski operators in the country, Vail Resorts is made up of five ski resorts in Colorado, California and Nevada, all of which operate on National Forest System lands.

In all of my dealings with Harris Sherman, I have known him to be incredibly balanced in his approach to issues and problems. He does a remarkable job of bringing competing interests to the table and creating an environment for them to work cooperatively. As you well know, he has had great success as the Director of the Colorado Department of Natural Resources doing just that, particularly spearheading the new oil and gas regulations that passed through the Colorado legislature this year.

Harris Sherman has spent his life working on environmental issues. His commitment to working to preserve and protect the natural resources and iconic landscapes that make up our beautiful country is unmatched. I strongly believe that Mr. Sherman will bring these values to USDA at a time when leadership in creating policies that protect the environment now and into the future is critical.

Harris Sherman would be a true asset and provide great leadership for the Administration. Thank you for your consideration.

Sincerely,

Rob Katz
CEO and Chairman
Vail Resorts

Robert Katz • Chief Executive Officer

Vail Resorts, Inc. • 390 Interlocken Crescent, Suite 1000 • Broomfield, CO 80021 • vailresorts.com
Direct 303 404 1801 • 303 404 6401 • rkatz@vailresorts.com

9

QUESTIONS AND ANSWERS

SEPTEMBER 30, 2009

Senator Blanche L. Lincoln

Question for Commissioners Chilton and Sommers

On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

QUESTIONS FOR AVALOS

AMS: FRESH PRODUCE PROCUREMENT FOR NUTRITION PROGRAMS

The Agricultural Marketing Service (AMS) has responsibility for purchasing the food that is distributed to schools, food banks, and other institutions through USDA's nutrition and food assistance programs. Over the years, the amount of fresh produce purchased by AMS has steadily declined to the point that fresh produce represents less than 5 percent of the total value of food purchased in any given year. Recently, AMS has begun several pilot programs to purchase fresh-cut produce for distribution to schools participating in the National School Lunch Program (NSLP). Many would like to see these programs expanded in as expeditious a manner as possible.

Can we have your assurance that, if confirmed, you will work quickly to develop and implement a plan to continue the expansion of AMS's fresh-cut produce purchases?

AMS: PROCESS VERIFIED MEAT LABEL CLAIM STANDARDS

Currently, both AMS and the Food Safety and Inspection Service (FSIS) verify claims made on meat product labels. The result can be uncertainty and confusion for consumers as to what it is they are purchasing, and hardship for farmers and ranchers using alternative methods of production.

Can we have your assurance that you will work with the yet-to-be-named Under Secretary for Food Safety to develop a clear, consistent policy between AMS and FSIS to verify package-label claims with respect to animal production?

APHIS: EMERGENCY PEST AND DISEASE SPENDING

For some time, Congress and the Office of Management and Budget (OMB) have been locked in a disagreement over how to spend emergency funds to fight plant pests. Congress has passed laws to direct the Secretary of Agriculture to use emergency funds when necessary to combat pest outbreaks, only to have OMB later block such spending. In the recent farm bill, Congress again made explicit that these funding decisions belong exclusively to USDA.

if confirmed, can the committee have your assurance that you will work with OMB to ensure that these funding decisions are based on the statutory direction provided in the farm bill?

APHIS: LACEY ACT IMPLEMENTATION

The Lacey Act is the nation's oldest wildlife protection statute. The Act has served as a key tool to combat trafficking in illegal wildlife, fish or plants. Section 8204 of the Food, Conservation and Energy Act of 2008 expands Lacey Act protections to a broader range of plants that are illegally taken with a few exceptions. Excluded from coverage are "common cultivars", except trees, and "common food crops". APHIS has been working to define these two terms for over a year. It's important that APHIS quickly define these terms to help provide clarity for many stakeholders.

Can I have your assurance that you will work with the Animal and Plant Health Inspection Service (APHIS) to provide a definition for these terms as quickly as possible?

Additional Questions for Edward M. Avalos to be Under Secretary of Agriculture for Marketing and Regulatory Programs:

The current Administration and USDA have made Global Food and Energy Security two of their top priorities for American agriculture to play a key role in. Secretary Vilsack has highlighted the role of technology in meeting those goals. Biotechnology, because it allows producers to produce more with less, is one technology that is key in my mind, especially in helping to meet the global population demand for safe food products. Would you agree?

In order for producers and consumers to realize the benefits of agricultural biotechnology, it is essential that USDA implement a timely and science-based approval process for the innovative biotech products waiting to be approved.

It is my understanding that currently the average length of time for agency decision making on petitions for regulatory approval of agricultural of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at present.

This trend is problematic and recent developments with regard to two specific crops have been brought to my attention.

Two and a half years ago, a Federal Court ruled that USDA should have conducted an Environmental Impact Statement before deregulating Roundup Ready alfalfa. Farmers lost the ability to plant biotech alfalfa until USDA completed what APHIS predicted to be a two-year EIS process.

Given the economic crisis that dairy farmers face and the importance of high-quality alfalfa to milk production, it is important USDA make this a priority. The same court just ruled that USDA needs to do an EIS for biotech sugarbeets. It would be logical to conclude more EIS reviews of biotech crops are in USDA's future.

In the near term, what is USDA going to do to complete the overdue EIS for Roundup Ready alfalfa? Is there a commitment of priority and resources to complete the sugarbeet EIS in a more timely way? And in the long-term, how will USDA ensure timely completion of future Environment Impact Studies so that the U.S. regulatory process does not go from being the gold standard of the world to a barrier for much needed innovation?

Finally, how can this Committee be helpful in assuring that USDA has and is utilizing the necessary resources to process science base approvals of ag biotech products in a timely fashion?

Senator John Barrasso, M.D.

Questions for the Record

Senate Committee on Agriculture, Nutrition and Forestry

CFTC, USDA, Farm Credit Nominations Hearing

10:00am, Wednesday, September 30, 2009

Harris D. Sherman, of Colorado, to be Under Secretary of Agriculture for Natural Resources and Environment and to be a Member of the Board of Directors of the Commodity Credit Corporation

1. In Wyoming, where more than half of the state is public land, we are keenly aware of the U.S. Forest Service responsibility for management of its lands. Currently, we face an unprecedented bark beetle infestation that threatens our forests and communities. If confirmed, how will you address the following management challenges related to this infestation?
 - a. Programmatic funding for Regions 2 and 4 of the U.S. Forest Service has historically fallen well below need. These regions have been disproportionately deprived of management resources. How will you address the funding needs for management of the bark beetle outbreak throughout Regions 2 and 4?
 - b. U.S. Forest Service local managers are facing an unprecedented forest health event. What management authorities do you believe need to be adjusted to meet the challenges posed by this infestation? Specifically, how will the Department, under your direction, address each of those needs?
 - c. Bark beetle infestation spreads beyond political boundaries. We must take a regional approach to management of our forests. Specifically, how will you promote regional action to regional management of the bark beetle infestation?

2. Our forest products industry partners are struggling in this economy. Many of the industry partners who historically helped manage federal forests are no longer in business. This increases the burden on federal agencies and weakens our local communities. If confirmed, how will you promote business friendly practices at U.S. Forest Service to sustain and regrow the American forest products industry?

3. U.S. Forest Service recently proposed spending \$2.8 million of wildland fire management funding under PL 111-5, the "American Recovery and Reinvestment Act," in Washington, D.C. Of the 5.5 million acres of wildlands nationwide, as defined by the National Interagency Fire Center, Washington, D.C. has none. There is no need for wildland fire management funding in the District of Columbia. While the kind of State and Private Forestry projects proposed for Washington, D.C. have merit, wildland fire management funding should not be diverted for this purpose. U.S. Forest Service must prioritize its limited resources to meet its basic responsibilities. Wyoming communities depend upon adequate management of U.S. Forest Service lands and we demand that the agency get its

priorities straight. If confirmed, how will you direct U.S. Forest Service to prioritize its wildland fire management budget in the future?

4. If confirmed, will you join Secretary of Interior Ken Salazar in supporting west-wide good neighbor authority, that would allow BLM and U.S. Forest Service to enter cooperative agreements with the states to implement forest health projects?
5. U.S. Forest Service renewal of grazing permits is continually backlogged. This is a detriment to public land ranchers and to the day-to-day operation of the U.S. Forest Service range management. If confirmed, specifically how will you address the permit backlog and improve the agency's handling of grazing permit renewals?

Questions from Sen. Max Baucus for nominees considered by the Committee on Agriculture on September 30, 2009

To: Mr. Harris Sherman, Nominee for Undersecretary for Natural Resources and the Environment, United States Department of Agriculture

Congratulations on your nomination to be Undersecretary for Natural Resources and the Environment for the Department of Agriculture. I am pleased that the President has chosen someone with your experience dealing with issues facing the forests, prairies and water resources of the West.

If confirmed, you will oversee programs and implement authorities that have a major impact on the economy and natural environment of my state. One authority the Forest Service has at its disposal is the ability to enter into stewardship contracts that enable it to trade logs and other goods to help carry out projects that reduce hazardous fuels, improve watersheds and other important forest management goals.

Stewardship contracting is very popular in Montana, helping form collaborative partnerships among diverse groups of forest users such as the wood products industry, the conservation community and sportsmen. Stewardship contracting also makes good economic sense for the Service. On one ranger district in my state, stewardship contracting enabled the ranger to perform nearly \$1 million of service work for which the district did not have appropriated funds.

While I am pleased that use of stewardship contracting is gradually increasing, I want the Forest Service to do much more. Since the Service was given broader contracting authority in 2003, it has completed only 34 contracts in the Northern Region. Most other regions have completed even fewer. I would like to know if you, as undersecretary, would work to substantially increase use of stewardship contracting, not only in my state, but across the nation. Does the Forest Service need any additional authorities to improve and increase the use of stewardship contracting and agreements?

Additionally, some non-profit groups have told me the Forest Service has been inflexible in determining matching requirements for stewardship agreements. The stewardship authority provides Forest Service and Bureau of Land Management personnel the same discretion in establishing matching requirements. Yet, the Forest Service requires a 20 percent match from non-profits, while the BLM requires no firm match. These non-profits can be valuable partners in stewardship projects and the Service should be more creative in evaluating their contributions. I would like to know if you will take steps to encourage non-profit participation in stewardship agreements.

To Bartholomew Chilton, Jill Sommers and Scott O'Malia, nominees for Commissioners of the Commodity Futures Trading Commission:

Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

U.S. Senator Maria Cantwell
Questions for CFTC Nominees
September 30, 2009

Mr. Chilton, O'Malia, and Ms. Sommers:

1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?
2. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?
3. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?
4. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and

index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

5. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?
6. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the "recklessness" standard instead of the current "specific intent" standard, how would this improve the Commission's ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?
7. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the "Treasury Proposal to Regulate OTC Derivatives" and "CFTC Legislative Language" as it relates to this proposal. In reviewing GMAC membership as posted on the Commission's website, it appears that the committee's membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

Sen. Saxby Chambliss
Questions for the Record
Nomination Hearing
September 30, 2009

Mr. Sherman

1. As I mentioned at the hearing, I have been contacted by several constituents about your nomination. They raise concerns about your approach to managing federal, state and private land. Below is a list of the concerns I have received. Please respond to these concerns.
 - Harris Sherman supports the Clinton-Babbitt Roadless rule and has worked in Colorado to revert to the Clinton-Babbitt Roadless Rule.
 - He would be a threat to oil and gas, mining, coal mining, timber, grazing, gravel extraction and recreation and much more.
 - According to residents of Colorado, Sherman used his position to extort or shake down money from oil and gas firms to fund his wildlife studies in return for his office not opposing their permits. In effect, he set up a "pay to play" approval process for oil and gas permits under the Colorado Dept. of Wildlife.
 - He rewrote important environmental documents with the assistance of environmental activist groups negating public meetings and public comment.
 - Environmental groups had special access under Harris not available to the public or other land users.
 - He set up rules that infringed on private property.
 - He set up a system whereby the CO Dept. of Wildlife could interfere with private contracts between farmers, ranchers and landowners and oil and gas and mining companies. He was able to blow up private contracts where he did not want oil and gas or mining operations to occur.
 - It is likely he will give environmental groups special control over the US Forest Service. His pattern is to feather his own nest and he would likely use the Forest Service to do that as he did in Colorado.

2. The U.S. Department of Agriculture (USDA) seems to be carefully tracking stimulus projects which are supporting the use of wood fiber for the production of biomass energy. However, despite receiving more than \$500 million for hazardous fuels reduction projects, it appears that almost none of these projects will produce wood fiber that can be used by the traditional sawmill and paper mill industries. Please tell me how many ARRA projects have produced merchantable wood fiber? How much volume in board feet or cubic feet did those produce? Please tell me whether ARRA funds have been used to pay for the non-merchantable component of stewardship contracts, allowing the commercial component to go forward in down timber markets?

3. Recently, Secretary Vilsack announced his vision for the role of USDA in managing public and private forests. His "all landscapes" approach suggests that USDA will take an active role in matters affecting private forests, including their participation in climate change and energy policies and their role in addressing environmental services, like clean

water and air and providing wildlife habitat. Working forests are a significant part of the jurisdiction of this committee, and we want to make sure that any policies affecting working forests are developed with the full participation of private forest owners and this committee. Will you fully involve private forest owners in the development of USDA policies on working forests? Will you fully involve this committee in any policies USDA develops on working forests? Will you commit to working with the committee to explore policy opportunities together that will promote the benefits of working forests?

Mr. Avalos

1. Agricultural biotechnology is a key priority of mine. It is important that farmers across the country have access to the best technology available. Of course, we must ensure that the products are safe and the regulatory process is based on sound science. It is this need for a timely and science-based approval that concerns me. As noted by Chairman Lincoln at the hearing, the average length of time for agency decision making on petitions for regulatory approval of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at the present time.

Will you develop a plan to get those products deemed safe to market more quickly? Will you provide a report to the Committee within 90 days regarding the cause of the delays and how USDA plans to ensure the Department issues scientifically based regulatory decisions in a timely manner?

2. Mr. Avalos, as you know, if confirmed you will be overseeing the APHIS Biotechnology Regulatory Services. Now pending within the USDA is the publication of draft Environmental Impact Statement to determine whether Round-Up Ready Alfalfa (RRA) can be deregulated. The completion of this EIS has taken far longer than anyone anticipated and is now jeopardizing the ability of farmers to have RRA available for the 2010 planting season. Would you commit to reviewing this problem and reporting to the committee when the EIS will be finalized and published in the *Federal Register*?
3. Over the last 15 years, business practices in the livestock industry have changed dramatically. Producers and meat companies have largely turned to alternative marketing arrangements, rather than the traditional spot market for livestock. The Grain Inspection, Packers & Stockyards Administration released a Congressionally-mandated study in 2007 of marketing issues and packer ownership of livestock. This exhaustive study concluded that alternative livestock marketing agreements benefit both producers and industry. Industry concentration is also a concern for some, but the 2008 Packers & Stockyards Administration Annual Report indicates that concentration has largely led to lower prices for consumers and better income margins for producers and processors. This Committee also held a hearing on these issues in 2007. Despite previous extensive study of this issue, USDA and the Department of Justice have announced a series of Public Workshops next year to address competition and concentration issues in the agriculture sector. Given your responsibilities will include overseeing GIPSA, do you feel there are problems in the industry that GIPSA is not policing? Will you provide the Committee with a detailed description of USDA's plans for any changes in policy or operations within GIPSA or in its relationship with the Department of Justice?

4. The Animal & Plant Health Inspection Service currently has a rule pending that would allow for importation of cooked pork skins from regions affected with swine diseases. This rule was proposed after a risk assessment concluded that cooking methods were sufficient to inactivate any pathogens of concern. APHIS for decades has protected U.S. agriculture by ensuring that imports from affected countries are processed in a manner that eliminates any potential harm. APHIS issued a proposed rule on July 2, 2008, and the agency's examination of this matter dates back to 2003. This rule received very few public comments, and does not appear to have raised many issues. Will you provide an update to the Committee regarding the status of the proposed regulation and when the Department plans to release a final rule?

5. As Under Secretary, you will oversee the National Organic Program. Secretary Vilsack has expressed a new commitment to the program and to help producers who choose to raise and market organic crops and livestock. However, organic production and certification can be a costly process. Congress has addressed this with the Organic Certification Cost-Share Program, and I applaud USDA for releasing the 2009 program this week. In 2008, USDA revised its accreditation procedures for certifying agents in the National Organic Program. This revision has raised concerns with some certifying agents that their costs could increase markedly. Many of these certifying agents are non-profit and public entities, and serve smaller local organic producers who cannot afford high administrative costs. Will you work with the new leadership of the National Organic Program to develop a plan to lower administrative costs and the burden on small producers and report to the Committee on your progress?

Senator Thad Cochran
Nomination Hearing Questions
September 30, 2009

Mr. Avalos, the Department of Agriculture is working to finalize a rule allowing for the importation of cooked pork skins subject to certain processes to protect public health. When do you expect the Department to finalize this important rule? Also, do you believe the Department should follow different rules for beef and cooked pork skins when approving countries for imports? I ask that you review this issue and work to finalize the rule.

Senator Charles E. Grassley
Nominations Hearing Questions
September 30, 2009 10:00am

CFTC

Bartholomew Chilton, Commissioner of the Commodity Futures Trading Commission
Jill Sommers, Commissioner of the Commodity Futures Trading Commission
Scott O'Malia, Commissioner of the Commodity Futures Trading Commission

- 1) This question is just for Ms. Sommers and Mr. O'Malia. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?
- 2) In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?

USDA

Edward M. Avalos, Under Secretary of Agriculture for Marketing and Regulatory Programs

- 1) Specifically related to Packers and Stockyards Program, how do you intend to make sure there is greater enforcement of the competition provisions of the P&S Act?
- 2) One of the most critical jobs within the MRP mission area is the biotechnology approval process at the Animal Plant Health Inspection Service. The U.S. is the leader in developing and using biotechnology and it should remain that way. However, over the last decade the time to deregulate these new products has slowed considerably. Will you make deregulation a priority within your mission area and can you assure me that these decisions continue to be based on science?

Farm Credit

Kenneth Albert Spearman, Member of the Farm Credit Administration Board

- 1) As you know many in the agriculture sector and in particular livestock producers are struggling to stay afloat. On top of the tough economic times they are facing, now it seems as if credit is also drying up. Many banks have looked at their agricultural portfolio as a liability and that in turn has added another burden to our producers. What

do you see as the role of the Farm Credit Administration in working with the farm credit system member banks to help these producers through this economically uncertain time?

QUESTIONS SUBMITTED BY SENATOR HARKIN TO HARRIS SHERMAN

1. The Food, Conservation, and Energy Act of 2008 (FCEA) reflects carefully balanced and integrated compromises. Among the most important decisions by Congress was the agreement to include some \$4 billion in additional funding for conservation programs over 10 years above budget baseline levels. The policies enacted and funded in the legislation are being effectively used, for example, in the recently-announced Mississippi River Basin Initiative, which makes extensive use of funding from the Environmental Quality Incentives Program (EQIP) and authority from the Cooperative Conservation Partnership Initiative.

Do you agree that in light of the significant demands and need for conservation on agricultural land it would be unwise to cut back on the funding committed to conservation in the FCEA?

2. In recent audits by the Department of Agriculture Office of Inspector General of the Wetlands Reserve Program and the Conservation Security Program the OIG identified failure to ensure compliance with the program requirements. This problem traces back, in my view, to insufficient funding being allocated for Natural Resources Conservation Service technical assistance personnel and activities so that conservationists can carry out conservation programs, including necessary compliance checks. For instance, the number of acres enrolled in the Wetlands Reserve program has continued to increase, and therefore the cost of monitoring and enforcing WRP easements has continued to rise, but the technical assistance support funding allocated for the program has stayed relatively flat at around 5 percent of total WRP funding. Currently, WRP technical assistance cost for monitoring and enforcement are an estimated \$12 an acre, but allocated funding for these activities are only around \$6 an acre.

How will you ensure that sufficient funding is allocated to NRCS technical assistance personnel and activities so that conservation programs can be carried out and delivered to farmers and ranchers properly, and so that NRCS can fulfill its core responsibility to enforce the statutory regulatory requirements of programs?

QUESTIONS SUBMITTED BY SENATOR HARKIN TO EDWARD AVALOS

1. In March 2006, the Government Accountability Office issued a report laying out continuing problems with the Grain Inspection and Packers and Stockyards Administration's enforcement of the Packers and Stockyards Act and evaluating steps taken to respond to recommendations in an earlier GAO report from 2000. In particular, the report disclosed that the agency was artificially inflating its own records on taking enforcement actions against unfair trade practices, for example, by directing employees to categorize taking a phone call complaint from the public as opening an investigation, even if no further action were ever taken.

If you are confirmed as Under Secretary, will you meet with GIPSA officials having responsibility for enforcing the Packers and Stockyards Act, go over the steps have been taken to address the matters raised in the 2006 GAO report, and report back to this Committee and to me regarding your findings and your plan for remedying shortcomings in enforcement and ensuring that reforms in GIPSA's performance are not allowed to lapse?

2. There are indications that, due to high demand, the Department is more actively integrating issues and concerns relating to organic agriculture into the activities of the various agencies within USDA. A number of agencies have staff working on various aspects of organic agriculture and trade, including the recent announcement of organic equivalency standards with the government of Canada.

What can we expect to see from AMS, and from the Marketing and Regulatory Programs branch more generally, involving interagency and interdepartmental coordination to ensure that issues of concern related to organic agriculture and trade are addressed systematically and comprehensively throughout the federal government?

2. The Food, Conservation, and Energy Act of 2008 (the farm bill), includes \$22 million in mandatory funding over the next five years for cost-share payments for producers to help offset the cost of organic certification fees. This was a major increase over the \$5 million provided for this program in the Food Security and Rural Investment Act of 2002. Many producers contacted me to indicate their frustration with how slowly the Department moved in getting this funding out to organic farmers in the period following passage of the 2002 bill. Such delays should not be repeated in implementing the 2008 farm bill.

Can we have your assurance that you will work closely with the leadership of the National Organic Program so that cost-share funding is distributed in a timely fashion to producers?

3. In 2007, USDA solicited public comments through the Federal Register to gather recommendations as to whether the Department should proceed to develop a national marketing agreement for leafy green vegetables. USDA received over 1500 public comments, including many from smaller-scale and organic producers who were concerned about the negative impacts that such an agreement would have on their farm operations. Currently, the Agricultural Marketing Service is conducting hearing sessions throughout the United States to continue

gathering public comments on whether to develop such a marketing agreement. At the hearing session conducted in Monterey, California, testimony from members of the organic and small-scale farming community reiterated the concerns expressed during the 2007 public comment period.

Will you commit to monitor closely the results of the hearing sessions and appropriately consider and evaluate the impact that a national marketing order may have on smaller and organic producers of leafy green vegetables?

QUESTION SUBMITTED BY SENATOR HARKIN TO KENNETH SPEARMAN

Mr. Spearman, you serve as an outside board member for the AgFirst Farm Credit Bank, and this experience clearly provides you with valuable background and knowledge for serving on the board of the Farm Credit Administration (FCA). AgFirst is one of the institutions of the Farm Credit System (FCS), all of which you will be tasked with overseeing as a member of the FCA Board. To be sure, you have pledged that you will if confirmed resign from the AgFirst board and comply with the applicable conflict of interest and ethics requirements.

As a regulator you will be tasked with ensuring the safety and soundness of the FCS and also ensuring that lending by FCS institutions complies with the statutory objectives, requirements, and limitations of the Farm Credit Act of 1971, as amended. The recent turmoil in the global financial system obviously underscores the crucial importance of enforcing prudent safety and soundness standards. At the same time, as a board member of the FCA, you will have a responsibility to help facilitate FCS institutions in making affordable credit available to borrowers who are eligible under the Act.

In the light of your previous position on the board of a FCS institution, please describe carefully the approach you will take and any specific steps involved to make sure that in your new position as a member of the board of the FCA you will be truly objective, even-handed, and free of pre-determined conclusions in handling the various questions that will come before you.

Questions for Bartholomew Chilton, of Maryland, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Jill Sommers, of Kansas, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. In a recent speech and in your testimony, you noted that the CFTC has to prove that someone "specifically intended" to manipulate prices. As a former prosecutor, I know chasing criminals isn't easy, but this standard would seem to make it even more difficult to go after criminals. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Scott O'Malia, of Michigan, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Edward M. Avalos to be Under Secretary of Agriculture for Marketing and Regulatory Programs and to be a Member of the Board of Directors of the Commodity Credit Corporation

1. Mr. Avalos, the Animal and Plant Health Inspection Services announced an increase in the user fees for agricultural quarantine and inspection (AQI) services on September 28, 2009 (Monday). The fee is scheduled to take effect on October 1, 2009 (Thursday). USDA has indicated this rapid (three-day) phase-in is required because fee collections have been down and layoffs of experienced employees would be necessary if the new fee were not adopted. I have heard from airlines in my state that the time and work required to change computer systems to accommodate this rapid phase-in of a new fee is not

sufficient. **As Under Secretary, what would you do to resurrect this situation or avoid this situation in the first place?**

2. Mr. Avalos, now pending within the USDA is the publication of a draft environmental impact statement to determine whether Round-Up Ready Alfalfa can be deregulated. Are you familiar with this issue and do you support biotechnology as a means of improving the productivity of the agriculture sector? Are you aware of the USDA's timeline for publishing this draft environmental impact statement and, if confirmed, would you provide that information to the committee?

Senator Pat Roberts
Committee on Agriculture, Nutrition and Forestry
Questions for the Record
September 30, 2009

Questions for Commissioners Sommers, Chilton and Mr. O'Malia:

1. What is your definition of "systemic risk?" Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a "systemic risk" as some are suggesting?
2. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

Question for Mr. Avalos:

Congress took action in the 2008 Farm Bill to reform certain aspects of the livestock industry, particularly in regards to contracts and the enforcement of the Packers and Stockyards Act. The agreements reached in the conference report were heavily scrutinized and exhaustively debated. All sides made concessions and the end result was a bill that passed by historic margins. I understand some would like the administration to ignore these agreements and implement measures that Congress either specifically voted down or chose not to include in the Farm Bill. Can you assure me that your mission area will follow the will of Congress by honoring the commitments made in the 2008 Farm Bill?

**Senator Stabenow – Questions for the Record for Nominees
October 1, 2009**

For Edward Avalos:

1. According to the Agriculture Appropriations bill that is working its way through the legislative process, the Appropriations Committee expresses its concern about the ever-increasing number of non-native plant pests and diseases discovered in the US. In this report language, the Committee urges APHIS to address the issue and undertake extremely careful review of requests for importation from growing regions that are home to pests and diseases that do not currently exist in the U.S., so as not to add to the current pest and disease crisis. In Michigan, pests and diseases are a huge obstacle for agriculture and threaten the viability of the industry. As Under Secretary of Marketing and Regulatory Affairs, what would you do to ensure that USDA is preventing new pests and diseases from entering the country due to agricultural importation? Are you willing to work with the Senate to prevent this ever-growing problem?
2. The current AMS commodity purchase programs face many implementation challenges. Additionally, commodities that are harvested in mid to late summer often have a disadvantage for government purchase within the current system. How do you plan to improve AMS acquisition of commodities to help deal with surpluses at times when food banks are short?

For Harris Sherman:

1. What is your understanding of the authority given to USDA by section 1245 of the Farm Bill, and how do you foresee this authority being carried out over the next several years?
2. As Congress continues to debate climate legislation, what can USDA be doing now to develop methodologies and standards for GHG emission reductions in agricultural and forestry offset projects?
3. The President has committed to and Congress is ready to pass over \$400 million for Great Lakes Restoration projects. This funding will build upon the work that many Great Lakes stakeholders have been working to develop for over 5 years. Given that your position with USDA would oversee some of the largest federal conservation programs, how can USDA play a more vital role in Great Lakes restoration process?
4. Should you be confirmed, how can USDA better collaborate with EPA to ensure land management programs are more successful in the future?

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Edward Avalos
September 30, 2009

Senator Blanche Lincoln

1) **Question:**

AMS: FRESH PRODUCE PROCUREMENT FOR NUTRITION PROGRAMS

The Agricultural Marketing Service (AMS) has responsibility for purchasing the food that is distributed to schools, food banks, and other institutions through USDA's nutrition and food assistance programs. Over the years, the amount of fresh produce purchased by AMS has steadily declined to the point that fresh produce represents less than 5 percent of the total value of food purchased in any given year. Recently, AMS has begun several pilot programs to purchase fresh-cut produce for distribution to schools participating in the National School Lunch Program (NSLP). Many would like to see these programs expanded in as expeditious a manner as possible.

Can we have your assurance that, if confirmed, you will work quickly to develop and implement a plan to continue the expansion of AMS's fresh-cut produce purchases?

Response:

Children having access to more fruits and vegetables in the National School Lunch program is very important for encouraging a lifetime of healthy eating. If confirmed as Under Secretary, I would want to conduct a top to bottom review of how AMS purchases food products for the National School Lunch program and figure out best strategies for increasing fruit and vegetable purchases. I would look forward to an opportunity to develop a plan and work with you to share views on this important topic.

2) **Question:**

AMS: PROCESS VERIFIED MEAT LABEL CLAIM STANDARDS

Currently, both AMS and the Food Safety and Inspection Service (FSIS) verify claims made on meat product labels. The result can be uncertainty and confusion for consumers as to what it is they are purchasing, and hardship for farmers and ranchers using alternative methods of production.

Can we have your assurance that you will work with the yet-to-be-named Under Secretary for Food Safety to develop a clear, consistent policy between AMS and FSIS to verify package-label claims with respect to animal production?

Response:

Yes. I know producers are looking for new marketing claims that can add value to their products, but also realize that such claims only have value if they can be verified. My understanding is that FSIS is required to ensure all claims associated with federally inspected meat, poultry and egg products are truthful. If confirmed, I will place a priority on having AMS assist FSIS using AMS' independently verified production activities. I look forward to working with FSIS to provide improved coordination on this issue.

3) Question:

APHIS: EMERGENCY PEST AND DISEASE SPENDING

For some time, Congress and the Office of Management and Budget (OMB) have been locked in a disagreement over how to spend emergency funds to fight plant pests. Congress has passed laws to direct the Secretary of Agriculture to use emergency funds when necessary to combat pest outbreaks, only to have OMB later block such spending. In the recent farm bill, Congress again made explicit that these funding decisions belong exclusively to USDA.

If confirmed, can the committee have your assurance that you will work with OMB to ensure that these funding decisions are based on the statutory direction provided in the farm bill?

Response:

I am familiar with this issue, and if given the opportunity to join the team at USDA, I will work to ensure that any future emergency funding requests to fight plant pests are well-justified. I will also work to ensure an open dialogue between the Department and OMB, so that OMB understands the Department's reasoning for making any emergency funding decisions in safeguarding American agriculture.

4) Question:

APHIS: LACEY ACT IMPLEMENTATION

The Lacey Act is the nation's oldest wildlife protection statute. The Act has served as a key tool to combat trafficking in illegal wildlife, fish or plants. Section 8204 of the Food, Conservation and Energy Act of 2008 expands Lacey Act protections to a

broader range of plants that are illegally taken with a few exceptions. Excluded from coverage are "common cultivars", except trees, and "common food crops". APHIS has been working to define these two terms for over a year. It's important that APHIS quickly define these terms to help provide clarity for many stakeholders.

Can I have your assurance that you will work with the Animal and Plant Health Inspection Service (APHIS) to provide a definition for these terms as quickly as possible?

Response:

This is a new issue for me. While I have not been briefed by the USDA experts on this issue in great detail, I can commit to you that, if confirmed, I will work with the appropriate officials at USDA to gain a full understanding and appraisal of this issue. Certainly, implementing these new provisions and defining appropriate requirements is important. If confirmed, I will ensure that APHIS communicates with stakeholders and makes defining the terms you mention a priority to help bring resolution to this issue as soon as possible.

5) Question:

The current Administration and USDA have made Global Food and Energy Security two of their top priorities for American agriculture to play a key role in. Secretary Vilsack has highlighted the role of technology in meeting those goals. Biotechnology, because it allows producers to produce more with less, is one technology that is key in my mind, especially in helping to meet the global population demand for safe food products. Would you agree?

In order for producers and consumers to realize the benefits of agricultural biotechnology, it is essential that USDA implement a timely and science-based approval process for the innovative biotech products waiting to be approved.

It is my understanding that currently the average length of time for agency decision making on petitions for regulatory approval of agricultural of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at present.

This trend is problematic and recent developments with regard to two specific crops have been brought to my attention.

Two and a half years ago, a Federal Court ruled that USDA should have conducted an Environmental Impact Statement before deregulating Roundup Ready alfalfa. Farmers lost the ability to plant biotech alfalfa until USDA completed what APHIS predicted to be a two-year EIS process.

Given the economic crisis that dairy farmers face and the importance of high-quality alfalfa to milk production, it is important USDA make this a priority. The same court just ruled that USDA needs to do an EIS for biotech sugarbeets. It would be logical to conclude more EIS reviews of biotech crops are in USDA's future.

In the near term, what is USDA going to do to complete the overdue EIS for Roundup Ready alfalfa? Is there a commitment of priority and resources to complete the sugarbeet EIS in a more timely way? And in the long-term, how will USDA ensure timely completion of future Environment Impact Studies so that the U.S. regulatory process does not go from being the gold standard of the world to a barrier for much needed innovation?

Finally, how can this Committee be helpful in assuring that USDA has and is utilizing the necessary resources to process science base approvals of ag biotech products in a timely fashion?

Response:

I agree that the advances in plant biotechnology over the past several years have brought significant benefits to producers and our food security. Drought resistant varieties and yield-enhancing traits have the potential to significantly increase our production of food, feed, fiber, and fuel.

I appreciate your concern about the length of time it currently takes USDA to make a determination on petitions for biotechnology products. With advances in technology, however, comes increased responsibility by USDA to ensure sound decision-making with regard to field testing and deregulating the products of biotechnology. I understand that there is a regulatory framework in place for a reason, to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically robust documents. I also understand that it takes significant resources and time to comply with environmental regulations like the National Environmental Protection Act (NEPA). I assure you that if confirmed, I will examine USDA's regulatory approval process for biotechnology products, particularly the length of time to approve those products, and where and when possible, examine ways to address this issue.

The two court rulings on Roundup Ready alfalfa and sugar beets are also concerning to me, especially because they inject uncertainty into farmers' operations. If confirmed, I look forward to being briefed on these issues and working with the Committee to address the concerns you have raised.

Senator Saxby Chambliss

1) Question:

Agricultural biotechnology is a key priority of mine. It is important that farmers across the country have access to the best technology available. Of course, we must ensure that the products are safe and the regulatory process is based on sound science. It is this need for a timely and science-based approval that concerns me. As noted by Chairman Lincoln at the hearing, the average length of time for agency decision making on petitions for regulatory approval of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at the present time.

Will you develop a plan to get those products deemed safe to market more quickly? Will you provide a report to the Committee within 90 days regarding the cause of the delays and how USDA plans to ensure the Department issues scientifically based regulatory decisions in a timely manner?

Response:

This is an issue that is important to me and it is important to the USDA. Advances in plant biotechnology over the past several years have brought significant benefits to producers and our food security. Drought resistant varieties and yield enhancing traits have the potential to significantly increase our production of food, feed, fiber, and fuel. If confirmed, I plan to examine USDA's regulatory approval process for biotechnology products, determine why the length of time to approve those products that are deemed safe is increasing, and examine ways to address this issue. I would be pleased to report my findings to the Committee, as requested.

2) Question:

Mr. Avalos, as you know, if confirmed you will be overseeing the APHIS Biotechnology Regulatory Services. Now pending within the USDA is the publication of draft Environmental Impact Statement to determine whether Round-Up Ready Alfalfa (RRA) can be deregulated. The completion of this EIS has taken far longer than anyone anticipated and is now jeopardizing the ability of farmers to have RRA available for the 2010 planting season. Would you commit to reviewing this problem and reporting to the committee when the EIS will be finalized and published in the *Federal Register*?

Response:

I appreciate your concern about the timeline for determining whether RRA can be deregulated. At the same time, I understand that there is a regulatory framework in

place to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically robust documents. I also understand that it takes significant resources to comply with environmental regulations like the National Environmental Protection Act (NEPA). If confirmed, I look forward to giving this matter my attention and reporting to the Committee my findings.

3) **Question:**

Over the last 15 years, business practices in the livestock industry have changed dramatically. Producers and meat companies have largely turned to alternative marketing arrangements, rather than the traditional spot market for livestock. The Grain Inspection, Packers & Stockyards Administration released a Congressionally-mandated study in 2007 of marketing issues and packer ownership of livestock. This exhaustive study concluded that alternative livestock marketing agreements benefit both producers and industry. Industry concentration is also a concern for some, but the 2008 Packers & Stockyards Administration Annual Report indicates that concentration has largely led to lower prices for consumers and better income margins for producers and processors. This Committee also held a hearing on these issues in 2007. Despite previous extensive study of this issue, USDA and the Department of Justice have announced a series of Public Workshops next year to address competition and concentration issues in the agriculture sector. Given your responsibilities will include overseeing GIPSA, do you feel there are problems in the industry that GIPSA is not policing? Will you provide the Committee with a detailed description of USDA's plans for any changes in policy or operations within GIPSA or in its relationship with the Department of Justice?

Response:

A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace.

I understand that changes made to the Packers and Stockyards Act in the 2008 Farm Bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. If confirmed, I will work to move these rules along as quickly as possible and will keep you updated on this process.

I am also aware of the proposed joint workshops next year by USDA and the Department of Justice. Although I am not aware of any specific outcomes of these workshops at this time, I do think they will provide a valuable dialogue with

producers, consumers, retailers, packers and others in the industry on issues relating to competition and concentration in the marketplace.

4) Question:

The Animal & Plant Health Inspection Service currently has a rule pending that would allow for importation of cooked pork skins from regions affected with swine diseases. This rule was proposed after a risk assessment concluded that cooking methods were sufficient to inactivate any pathogens of concern. APHIS for decades has protected U.S. agriculture by ensuring that imports from affected countries are processed in a manner that eliminates any potential harm. APHIS issued a proposed rule on July 2, 2008, and the agency's examination of this matter dates back to 2003. This rule received very few public comments, and does not appear to have raised many issues. Will you provide an update to the Committee regarding the status of the proposed regulation and when the Department plans to release a final rule?

Response:

Although I do not know when the Department plans to finalize the rule on cooked pork skins, if confirmed, I will certainly look into this upon my arrival at USDA and see where the rule is in the process and work to move it along. I understand that the Department may receive many requests in any given year for different types of animal products to be let into the country, and that these products can be treated or handled in a variety of ways to mitigate potential disease risks. If confirmed, I would like to have an opportunity to assess and review the process that is used for prioritizing these types of commodity import requests and determine if changes should be recommended.

5) Question:

As Under Secretary, you will oversee the National Organic Program. Secretary Vilsack has expressed a new commitment to the program and to help producers who choose to raise and market organic crops and livestock. However, organic production and certification can be a costly process. Congress has addressed this with the Organic Certification Cost-Share Program, and I applaud USDA for releasing the 2009 program this week. In 2008, USDA revised its accreditation procedures for certifying agents in the National Organic Program. This revision has raised concerns with some certifying agents that their costs could increase markedly. Many of these certifying agents are non-profit and public entities, and serve smaller local organic producers who cannot afford high administrative costs. Will you work with the new leadership of the National Organic Program to develop a plan to lower administrative costs and the burden on small producers and report to the Committee on your progress?

Response:

Yes. Given my experiences in New Mexico and the shared experiences of the people I have worked with in that state, I can understand the concerns you raise regarding costs and its impacts on the bottom line. If confirmed, I would like to review how these costs are administered and develop strategies that could lower the overall cost. As a prospective leader and member of the USDA Subcabinet, I believe that through dialogue and thorough listening that even better solutions can be found. For example, there may be new ideas that have yet to be explored. I would be happy to report my progress to you.

Senator Tom Harkin

1) **Question:**

Question one In March 2006, the Government Accountability Office issued a report laying out continuing problems with the Grain Inspection and Packers and Stockyards Administration's enforcement of the Packers and Stockyards Act and evaluating steps taken to respond to recommendations in an earlier GAO report from 2000. In particular, the report disclosed that the agency was artificially inflating its own records on taking enforcement actions against unfair trade practices, for example, by directing employees to categorize taking a phone call complaint from the public as opening an investigation, even if no further action were ever taken.

If you are confirmed as Under Secretary, will you meet with GIPSA officials having responsibility for enforcing the Packers and Stockyards Act, go over the steps have been taken to address the matters raised in the 2006 GAO report, and report back to this Committee and to me regarding your findings and your plan for remedying shortcomings in enforcement and ensuring that reforms in GIPSA's performance are not allowed to lapse?

Response:

Yes. A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace. I will also review the audits conducted by both GAO and USDA's Office of Inspector General to ensure the recommendations have been properly implemented. I will report to you and the Committee GIPSA's

progress in improving its enforcement activities as outlined by both GAO and Office of Inspector General.

I am aware of the changes made to the Packers and Stockyards Act in the 2008 farm bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. I will work to move these rules along as quickly as possible and will keep you updated on this process as well.

2) Question:

There are indications that, due to high demand, the Department is more actively integrating issues and concerns relating to organic agriculture into the activities of the various agencies within USDA. A number of agencies have staff working on various aspects of organic agriculture and trade, including the recent announcement of organic equivalency standards with the government of Canada.

What can we expect to see from AMS, and from the Marketing and Regulatory Programs branch more generally, involving interagency and interdepartmental coordination to ensure that issues of concern related to organic agriculture and trade are addressed systematically and comprehensively throughout the federal government?

Response:

From my perspective, the 2008 Farm Bill provided needed resources and new provisions to carry out critical activities to support organic agriculture. I am committed to ensuring there is a structured process to coordinate activities within the Department on organic agriculture to make the most of these critical investments. I know the Department has already taken a number of steps to build a more cohesive structure for coordinating organic activities, and I want to help further facilitate those actions. If confirmed, I look forward to working with you on these issues in the future and value your input for helping identify new ways to strengthen organic agriculture issues at the Department.

3) Question:

The Food, Conservation, and Energy Act of 2008 (the 2008 Farm Bill), includes \$22 million in mandatory funding over the next five years for cost-share payments for producers to help offset the cost of organic certification fees. This was a major increase over the \$5 million provided for this program in the Food Security and Rural Investment Act of 2002. Many producers contacted me to indicate their frustration with how slowly the Department moved in getting this funding out to organic farmers

in the period following passage of the 2002 bill. Such delays should not be repeated in implementing the 2008 farm bill.

Can we have your assurance that you will work closely with the leadership of the National Organic Program so that cost-share funding is distributed in a timely fashion to producers?

Response:

From firsthand experiences in my home state of New Mexico, I can appreciate frustration people have when it is perceived the government is not moving quickly enough. I also know how important this program is for organic producers and handlers. As Under Secretary, I will review the process that is used in getting these funds out the door to ensure it is as expedient and efficient as possible for funds allocated from the 2008 farm bill.

It is also my understanding that funding for fiscal year 2010 was announced on September 30 so funds should be available to producers and handlers soon. If confirmed, I welcome the chance to dig deeper into this issue and help facilitate solutions that work for everyone.

4) Question:

In 2007, USDA solicited public comments through the Federal Register to gather recommendations as to whether the Department should proceed to develop a national marketing agreement for leafy green vegetables. USDA received over 1500 public comments, including many from smaller-scale and organic producers who were concerned about the negative impacts that such an agreement would have on their farm operations. Currently, the Agricultural Marketing Service is conducting hearing sessions throughout the United States to continue gathering public comments on whether to develop such a marketing agreement. At the hearing session conducted in Monterey, California, testimony from members of the organic and small-scale farming community reiterated the concerns expressed during the 2007 public comment period.

Will you commit to monitor closely the results of the hearing sessions and appropriately consider and evaluate the impact that a national marketing order may have on smaller and organic producers of leafy green vegetables?

Response:

Yes. If confirmed, I will monitor how the hearings are going and will carefully review the results as well with particular attention to any potential impact of an agreement on small and organic producers.

Senator Debbie Stabenow

1) **Question:**

According to the Agriculture Appropriations bill that is working its way through the legislative process, the Appropriations Committee expresses its concern about the ever-increasing number of non-native plant pests and diseases discovered in the US. In this report language, the Committee urges APHIS to address the issue and undertake extremely careful review of requests for importation from growing regions that are home to pests and diseases that do not currently exist in the U.S., so as not to add to the current pest and disease crisis. In Michigan, pests and diseases are a huge obstacle for agriculture and threaten the viability of the industry. As Under Secretary of Marketing and Regulatory Affairs, what would you do to ensure that USDA is preventing new pests and diseases from entering the country due to agricultural importation? Are you willing to work with the Senate to prevent this ever-growing problem?

Response:

Invasive pests are one of the greatest threats to agriculture and our environment today and I appreciate that we share the same concern. To address these threats, the United States needs a comprehensive approach. We must use the best and most up-to-date science to evaluate all potential risk and make informed decisions about whether to allow the entry of commodities from specific regions of the world. The approach also needs to involve stringent port-of-entry inspections, coordinated domestic surveillance efforts, and increased public awareness. If confirmed, I will urge vigilance at home and abroad and enhanced coordination with all of those involved in federal, state, local, international, and non-governmental organizations. I would like to have an opportunity to work further with you on this.

2) **Question:**

The current AMS commodity purchase programs face many implementation challenges. Additionally, commodities that are harvested in mid to late summer often have a disadvantage for government purchase within the current system. How do you plan to improve AMS acquisition of commodities to help deal with surpluses at times when food banks are short?

Response:

My understanding is that there are reduced funding levels for surplus purchases. I also know that many sectors in agriculture have faced severe economic trying times and are in need of support such as through surplus removals. If confirmed, I will work with AMS to develop a purchasing plan that addresses both the economic condition of the market and the needs of recipients.

Senator Amy Klobuchar

1) **Question:**

Mr. Avalos, the Animal and Plant Health Inspection Services announced an increase in the user fees for agricultural quarantine and inspection (AQI) services on September 28, 2009 (Monday). The fee is scheduled to take effect on October 1, 2009 (Thursday). USDA has indicated this rapid (three-day) phase-in is required because fee collections have been down and layoffs of experienced employees would be necessary if the new fee were not adopted. I have heard from airlines in my state that the time and work required to change computer systems to accommodate this rapid phase-in of a new fee is not sufficient. **As Under Secretary, what would you do to resurrect this situation or avoid this situation in the first place?**

Response:

I certainly appreciate the airline industry's concerns about the timeframe for implementation, and understand that APHIS has extended the implementation date by 30 days, to November 1, to provide the industry with additional time. If I am confirmed, I assure you that I will place a premium on timely and comprehensive communications and will work to ensure that my mission area provides as much notice as possible to stakeholders before implementing any future regulatory changes.

2) **Question:**

Mr. Avalos, now pending within the USDA is the publication of a draft environmental impact statement to determine whether Round-Up Ready Alfalfa can be deregulated. Are you familiar with this issue and do you support biotechnology as a means of improving the productivity of the agriculture sector? Are you aware of the USDA's timeline for publishing this draft environmental impact statement and, if confirmed, would you provide that information to the committee?

Response:

I currently do not know when the draft environmental impact statement will be published. I do, however, look forward to being briefed on it and updating the Committee accordingly. I understand that there is a regulatory framework in place to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically grounded. I also understand that it takes significant resources to comply with environmental regulations like the National Environmental Protection Act (NEPA).

Senator Pat Roberts

1) **Question:**

Congress took action in the 2008 Farm Bill to reform certain aspects of the livestock industry, particularly in regards to contracts and the enforcement of the Packers and Stockyards Act. The agreements reached in the conference report were heavily scrutinized and exhaustively debated. All sides made concessions and the end result was a bill that passed by historic margins. I understand some would like the administration to ignore these agreements and implement measures that Congress either specifically voted down or chose not to include in the Farm Bill. Can you assure me that your mission area will follow the will of Congress by honoring the commitments made in the 2008 Farm Bill?

Response:

I am aware of the changes made to the Packers and Stockyards Act in the 2008 farm bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. If confirmed, I will work to advance these rules as expeditiously as possible and will keep you updated on this process as GIPSA works to carry out the requirements set by Congress. I will also seek your input when the rules are published.

I appreciate that issues relating to the marketplace and enforcement issues can be very complex and require needed dialogue across all sectors of the industry. I know that there can be strong views on both sides with these issues and I want to have the benefit of learning as much as I can from all perspectives.

Senator Thad Cochran

1) **Question:**

Mr. Avalos, the Department of Agriculture is working to finalize a rule allowing for the importation of cooked pork skins subject to certain processes to protect public health. When do you expect the Department to finalize this important rule? Also, do you believe the Department should follow different rules for beef and cooked pork skins when approving countries for imports? I ask that you review this issue and work to finalize the rule.

Response:

Although I do not know when the Department plans to finalize the rule on cooked pork skins, if confirmed, I will certainly look into this upon my arrival at USDA and see where the rule is in the process and work to move it along. I understand that the Department may receive many requests in any given year for different types of animal products to be let into the country, and that these products can be treated or handled in a variety of ways to mitigate potential disease risks. If confirmed, I would like to have an opportunity to assess and review the process that is used for prioritizing these types of commodity import requests and determine if changes should be recommended.

Senator Charles Grassley

1) **Question:**

Specifically related to Packers and Stockyards Program, how do you intend to make sure there is greater enforcement of the competition provisions of the P&S Act?

Response:

A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. If confirmed, I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace.

I am also aware that USDA is undertaking rules to carry out the farm bill's Livestock Title, and I will work to move them along as quickly as possible.

2) **Question:**

One of the most critical jobs within the MRP mission area is the biotechnology approval process at the Animal Plant Health Inspection Service. The U.S. is the leader in developing and using biotechnology and it should remain that way. However, over the last decade the time to deregulate these new products has slowed considerably. Will you make deregulation a priority within your mission area and can you assure me that these decisions continue to be based on science?

Response:

Advances over the years for plant biotech have brought significant benefits to producers and our food security. If confirmed, one of my top priorities as Under Secretary would be to support and uphold a science-based regulatory process and to also ensure that our regulatory process is robust enough to address the evolving nature of biotechnology.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the Record
Commissioner Bart Chilton
September 30, 2009

Chair Blanche Lincoln

1) Question one. On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

You are correct that the cotton markets became dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. I requested an investigation (which had not begun) on this matter because of those very concerns. The Commission would be pleased to provide you with a comprehensive confidential briefing at your convenience on this matter. In addition, I have urged that this report be made public as soon as possible and that all aspect of the report that can be made public are available to ensure optimum transparency. It is my hope and expectation that the Commission will be able to make its findings public in the near future.

Senator Max Baucus

1) Question one. Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

Should the Commission is be given authority over carbon market trading, we will use our full authority to ensure transparency and accountability. This would include our complete enforcement and surveillance authorities such as large trader reporting and all other oversight authorities that are currently applicable to exchange trading of derivatives. In

addition, I believe it is important to ensure that there is a seamless market for all transactions and that can be best achieved through a single agency regulation of both the derivative and cash markets. Furthermore, I support ensuring that all significant trades related to these markets are done so in a regulated fashion and that any over-the-counter (OTC) trading is minimal and does not have the prospect of influencing the regulated price discovery process. Finally, by ensuring safe, sound, secure and transparent markets, derivatives industry participants will help create deep and liquid markets.

Senator Pat Roberts

- 1) **Question one. What is your definition of “systemic risk?” Do you believe every OTC participant or product creates “systemic risk” to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a “systemic risk” as some are suggesting?**

Section 3 of the Commodity Exchange Act charges the Commission with protecting against systemic risk, that is, financial system risk ensuing from transactions, series of transactions or events that have ripple effects across the broader economy. Certainly, every OTC product or participant does not present systemic risk to the financial market system, nor do I believe that the Administration's proposal regarding OTC regulatory reform treats them as such. The proposal's two-tiered approach--to bring more consistent oversight to standardized OTC products and to enhance prudential requirements for dealers in non-standardized products--is, I believe, a tailored approach to addressing potential risks to the financial system in order to avoid another financial market crisis

- 2) **Question two. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?**

With regard to the creation of a systemic risk regulator, I believe that this is a response to finding an single entity that can see aggregate risks common to financial market participants in various market sectors, the intent of which is, again, to lessen risks to the financial market system. I do not believe that the development of such an oversight system would have the perverse effect of creating barriers to entry and therefore increasing systemic risks.

Senator Charles E. Grassley

- 1) **Question one. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Comissinner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more**

transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?

The Commission, under the leadership of Chairman Gensler, had made significant improvements in enhancing transparency in energy and agricultural markets, including enhancements to commitment of trader reports and index trading reports, and we've also moved forward in the areas of consideration of position limits and hedging exemptions in finite commodity markets. As to the latter issues, I believe it is important that, at the same time the Commission considers how to impose reasonable and rational speculative position limits in finite commodities, we should be mindful of the OTC regulatory reform efforts currently under consideration by Congress, to ensure that our efforts at the CFTC do not have perverse consequences of moving currently regulated markets into what are now opaque venues. I am by no means advocating that the Commission wait for Congress to act; I am, however, noting that the Commission should ensure it take this dual track of regulatory and legislative efforts into consideration as it moves forwards in consideration of establishment of position limits.

- 2) **In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?**

Crude oil prices reached their apogee in July 2008, and as you correctly point out, there was a great deal of discussion at that time in Congressional hearings, at the Commission, and in the media as to whether speculative position limits should be imposed. It appears that, at least in part, these discussions--indicating to some that there was a possibility of legislative or regulatory action to limit speculative activity--did have some effect on trader activity, resulting in reduction of speculative long positions. While this certainly does not account for all of the decrease in crude oil prices since the highs of summer 2008, it appears that it had some effect. As I've said, I do not believe that speculators are "price drivers," only that their presence in the markets can have some price effects. Moreover, I believe that appropriate speculative trading is a necessary component to deep, liquid, properly functioning future markets.

Senator Amy Klobuchar

- 1) **Question one. In its 35-year history, the Commodity Futures Trading Commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?**

Thank you for the question, a recent federal court case in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of \$303 million--the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that case by bringing a criminal case against four of the participants in the scheme. Two weeks ago, the Texas judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met.

When comparing the CFTC's manipulation standard with that of the SEC, the SEC has a much easier legal hurdle to clear. The Federal Energy Regulatory Commission (FERC) and the Federal Trade Commission (FTC) have standards similar to the SEC's its "10b-5 rule" --which is their manipulation standard. To be more precise, under applicable case law the CFTC is required to prove "specific intent" to manipulate. That is a very difficult standard to reach, not to mention that it leaves a lot of space for mischief that is clearly prohibited by the Act, yet not categorically outlawed. In addition, our case law requires that we prove an artificial price exists, that the defendant had market power to move the price, and that he or she actually did cause the artificial price. Particularly in today's complex markets, proving "artificial price" can be a daunting task, which more often than not comes down to a "battle of the experts" in court. Because these requirements are so onerous, we often end up moving to a less significant charge of "attempted manipulation," which requires only proving intent and some act showing that intent. This is still a high standard, but is much easier than proving up a full manipulation case. I'm not saying that the answer is wholesale adoption of the SEC manipulation standard, but clearly, as Senator Cantwell and others have recently noted, we need to do something different at the CFTC. The status quo simply isn't good enough.

2) Question two. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Given current law, (with very rare exceptions) it is an inefficient and ineffective use of time and taxpayer dollars to prosecute financial crimes under our manipulation standard. With a new, more appropriate standard, we can prosecute and actually deter more manipulation events. I will note, however, that while we have a difficult time prosecuting manipulation cases, we are very good at prosecuting attempted manipulation cases and other violations of the CEA. In fact, our enforcement division is superb. At any one time, for example, we are investigating anywhere from 750 to 1,000 individuals or entities. We are one of the few government agencies who can say that the amount that we assess in fines and penalties could actually pay for our annual budget.

Senator Maria Cantwell

1) Question one. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the

commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?

Yes, I believe that the trading strategies of "non-traditional speculators"---those entities who take long, passive positions in the futures market and keep them indefinitely--can affect futures market prices, and that this price effect in the futures market can result in price changes in the cash commodity markets.

2) Question two. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?

Yes, I fully support the Administration's proposal to bring needed transparency and federal oversight to the currently unregulated OTC markets. I am supportive of Chairman Gensler's additional recommendations included in his August 17, 2009 letter to Chairman Harkin and Ranking Member Chambliss, and I believe they highlight the need to address issues in the OTC provisions of the Administration's proposal, particularly the foreign exchange swap issue, the appropriate definition of "standardized" swaps, and dual regulation of "mixed swaps."

3) Question three. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?

Yes, I believe that the Commission should address imposition of position limits in appropriate circumstances in finite commodities such as energies as metals. These limits have worked well in the agricultural arena for decades, and I believe that Commission-set

federal limits could bring needed oversight to other finite commodities that are critical to the American economy. I believe it is important that, at the same time the Commission considers how to impose reasonable and rational speculative position limits in finite commodities, we should be mindful of the OTC regulatory reform efforts currently under consideration by Congress, to ensure that our efforts at the CFTC do not have perverse consequences of moving currently regulated markets into what are now opaque venues. I am by no means advocating that the Commission wait for Congress to act; I am, however, noting that the Commission should ensure it take this dual track of regulatory and legislative efforts into consideration as it moves forwards in consideration of establishment of position limits.

- 4) **Question four. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?**

Yes, if it is done properly. I believe we need to both address the issue of position limits and at the same time review the important issue of addressing our current bona fide hedge exemption definition. Moving forward on the former with no consideration of the latter could make our efforts ineffective and not achieve the objectives that we are instructed to pursue under the Commodity Exchange Act.

- 5) **Question five. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I support consideration of all appropriate efforts to provide the agency with adequate funding to oversee regulated exchanges and market participants. I believe there is a public interest in ensuring that these markets operate efficiently and effectively and therefore believe that tax dollars should be used for needed increases in our regulatory efforts. That said, the most important thing to me is gaining the needed resources.

- 6) **Question six. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove “specific intent” to do harm, a much more difficult standard to prove than the “recklessness” standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC’s weaker anti-manipulation standard, market “manipulation cases generally have not fared well.” In fact, the standard is so weak that in the CFTC’s 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the “recklessness” standard instead of the current “specific intent” standard, how would this improve the Commission’s ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?**

I believe that a legislative change to provide the Commission with an "easier to prove" manipulation standard is critically important, and I thank you for your leadership on this important issue. As you correctly note, the current standard simply is ineffective in allowing the agency to detect, deter, and prosecute manipulation in America's commodity markets. This is not due to a lack of expertise or effort on the part of our enforcement staff; on the contrary, they do an excellent job, but their hands are tied by the almost impossibly high legal standard developed under manipulation case law. This is evidenced by a recent federal court case in Texas, a DOJ follow-on to CFTC's \$303 million BP civil manipulation settlement in 2007, in which the district court judge noted that, while he didn't condone the conduct of the four defendants involved in the scheme, he could not find them guilty of manipulation under the onerous commodities manipulation standard. A change such as your suggest would improve our ability to carry out the mission of the Commodity Exchange Act. We need a change in our law, and I fully and strongly support a legislative change to make that happen.

- 7) **Question seven. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the “Treasury Proposal to Regulate OTC Derivatives” and “CFTC Legislative Language” as it relates to this proposal. In reviewing GMAC membership as posted on the Commission’s website, it appears that the committee’s membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry.**

While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

The GMAC may hold a meeting at the discretion of the Chair, Commissioner Sommers; at this point, no firm date has been set for a meeting. With regard to future meetings of all agency advisory committees, I have in the past and will continue to fully support broad and diverse membership on such committees. In fact, as to the Energy and Environmental Markets Advisory Committee, which I chair, in the past year I significantly expanded not only the scope of the committee's mandate, but also the representation on the committee to ensure that consumer groups and others who formerly had not had a voice in that venue were included in the membership. I commit to continuing to ensure that membership of any CFTC advisory Committee fully complies with the requirements of the Federal Advisory Committee Act.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the Record

Scott O'Malia
September 30, 2009

Senator Charles Grassley

- 1) **When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?**

Under the leadership of former Acting Chairman Walt Lukken and Chairman Gary Gensler, the CFTC has expanded the collection of data as well as improved the fidelity of this information to better understand what impact non-commercial traders have had on the market. I support these efforts to bring transparency to the market and improve the quality of the data. If confirmed, I look forward to effectively utilizing this data to make informed policy decisions.

- 2) **In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?**

I believe one of the most significant factors that contributed to the decline in global oil price was the drop in global demand which also reduced pressure on our global capacity. When the price began to decline speculators and others did leave the market. While global demand has declined and prices have fallen, nothing has been done to relieve the capacity constraints in global markets, which could lead to price increases in the future. I believe we will likely to see prices rise significantly in the next few years when the U.S. and global economies recover. The Department of Treasury has proposed a financial reform bill that would impose position limit on energy derivatives. This tool has been used effectively in agriculture markets for the past 70 years. If applied to other commodities of finite supply, including energy markets, I do believe it could contribute to slowing the growth in oil prices, but will not correct the fundamental long term supply and demand pressures.

Senator Pat Roberts

- 1) **What is your definition of “systemic risk?” Do you believe every OTC participant or product creates “systemic risk” to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a “systemic risk” as some are suggesting?**

Systemic risk is the risk posed to an entire market as opposed to commercial risk posed by an individual company. Because of the interconnectedness in many markets, poor performance of one company can affect the entire market or system, rather than being isolated to the company with the poor performance. OTC derivatives are one way this interconnectedness proliferates through the system. However, not every derivative contract presents the same level of risk or capacity to destabilize markets. The Department of Treasury has offered a reform proposal that would regulate standard contracts and establish new risk based standards for customized products. If confirmed, I am committed to working with Congress and the Administration to develop legislative or regulatory proposals that strike the appropriate balance to enable commercial entities to cost-effectively hedge their risk while helping to avoid a repeat of the current financial crisis.

- 2) **This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?**

I believe we must ensure that we have completely transparent markets that enable all commercial participants to cost-effectively hedge their risk. This requires sufficient liquidity and an adequate number of counterparties to enable commercial entities to hedge their risk. I share your views that we should not create barriers to entry that prevent commercial interests from accessing these markets, which might leave participants vulnerable to commodity risk or encourage them to utilize foreign trading venues.

Senator Max Baucus

- 1) **Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.**

I believe the CFTC should be given authority over a carbon market, if Congress passes a cap and trade bill. The CFTC already regulates the small, but existing emissions trading systems and has the responsibility to oversee futures markets on regulated exchanges just like similar commodities. The CFTC also has regulations against manipulation and fraud. The Administration has proposed new rules to expand CFTC's authority over OTC markets which would greatly expand transparency in these markets. In order to ensure there is adequate liquidity, market participant must continue to be able to access transparent markets with low-barriers to entry. In order to carry out this mission, the CFTC will need additional personnel and resources to adequately oversee this potentially massive market.

Senator Amy Klobuchar

- 1) **In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?**

You are correct; the CFTC has only one successful prosecution. To obtain a conviction, the CFTC must be able to prove intent and that the defendant created an artificial price. The recent decision by the U.S. District Court in *U.S. v. Radley* highlights the challenges in obtaining a criminal conviction for manipulation. If confirmed, I will work with the Commission, the General Counsel and Division of Enforcement to review these standards and to identify appropriate regulatory reforms and recommend legislation that can provide the necessary tools in order to provide the CFTC with the necessary legal authority to prosecute manipulation in these markets.

- 2) **How will you ensure that the CFTC employs its authority to prosecute market manipulators?**

If confirmed, I intend to utilize the existing authorities to prosecute manipulation and attempt to manipulate. As I noted in the previous question, I will work with the Commission experts to determine what additional reforms are necessary. Further, I am committed to enforcing all violations of the Commodity Exchange Act. For these markets to work effectively, it is essential that all participants have the confidence that these markets are free from fraud and manipulation.

Senator Maria Cantwell

1. **Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?**

Yes, I agree all trading, including speculative trading, can have an impact on the futures price. Participants in the cash market often look to the futures for pricing information.

2. **On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?**

I support the Treasury initiatives to bring greater oversight to OTC markets, increase the utilization of clearing to enhance transparency and reduce systemic risk, and reduce the opportunity for abusive trading practices in our markets. I believe the Treasury proposal is a strong step towards appropriate regulation of the OTC markets, but I agree with Chairman Gensler that there are improvements that can and should be made. If confirmed, I look forward to working with Congress and the expert staff at the CFTC to ensure appropriate regulation of the OTC markets is enacted as soon as possible.

3. **The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities? Yes, I support the appropriate application of position limits for energy commodities. As the process proceeds, we should remain mindful of the broader goal of the Treasury proposal to bring more transactions under the oversight of market regulators. We must ensure that any position limit proposal does not have the effect of driving transactions from currently regulated and transparent markets to less regulated and opaque markets. I look forward to working with the Commission and Congress to develop a comprehensive position limit regime.**
4. **The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions**

have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

I believe existing hedge exemptions must be reassessed as part of the overall debate on position limits. To ensure position limits can be enforced across all markets will require additional authority from Congress. I am cognizant of the fact that any exemptions or loopholes that remain could enable traders to escape oversight using unregulated or international markets.

5. **The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I agree with you that the CFTC is woefully underfunded. I believe the resources of both staff and appropriations are insufficient to properly oversee the incredible growth in these markets. I am aware of past proposals to fund the CFTC from the collection of fees. I strongly support an increase in the CFTC budget, and if this proposal is reconsidered by Congress, it is important that the fees do not impose a burden that would discourage the commercial risk management strategies, reduce liquidity, or drive trades to unregulated markets.

6. **Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one**

single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the “recklessness” standard instead of the current “specific intent” standard, how would this improve the Commission’s ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?

I agree with you that the CFTC must achieve a high standard to prove manipulation, including proving both intent and an artificial price among others. I also agree that other federal agencies do not have the same burden of proof. The recent decision by the U.S. District Court in *U.S. v. Radley* further highlights the challenges in obtaining a criminal conviction for manipulation. If confirmed, I will work with the Commission, the General Counsel and Division of Enforcement to review these standards and to identify appropriate regulatory reforms and recommend legislation that can provide the necessary tools in order to provide the CFTC with the necessary legal authority to prosecute manipulation in these markets.

7. **On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the “Treasury Proposal to Regulate OTC Derivatives” and “CFTC Legislative Language” as it relates to this proposal. In reviewing GMAC membership as posted on the Commission’s website, it appears that the committee’s membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC’s charter requires representation of U.S. and foreign exchanges and market participants, it also requires “end users most directly involved in and affected by market globalization.” Without end user and consumer participation, the committee may also not be “fairly balanced in terms of the points of view represented” as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure “fairly balanced in terms of the points of view represented” as required under the Federal Advisory Committee Act?**

I agree with you that the committee should include end users and consumers. If confirmed, I am committed to ensuring all CFTC committees comply with Federal Advisory Committee Act requirements to include a broad and diverse membership.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Harris Sherman
September 30, 2009

Senator Saxby Chambliss

1) **Question:**

As I mentioned at the hearing, I have been contacted by several constituents about your nomination. They raise concerns about your approach to managing federal, state and private land. Below is a list of the concerns I have received. Please respond to these concerns.

- Harris Sherman supports the Clinton-Babbitt Roadless rule and has worked in Colorado to revert to the Clinton-Babbitt Roadless Rule.
- He would be a threat to oil and gas, mining, coal mining, timber, grazing, gravel extraction and recreation and much more.
- According to residents of Colorado, Sherman used his position to extort or shake down money from oil and gas firms to fund his wildlife studies in return for his office not opposing their permits. In effect, he set up a "pay to play" approval process for oil and gas permits under the Colorado Dept. of Wildlife.
- He rewrote important environmental documents with the assistance of environmental activist groups negating public meetings and public comment.
- Environmental groups had special access under Harris not available to the public or other land users.
- He set up rules that infringed on private property.
- He set up a system whereby the CO Dept. of Wildlife could interfere with private contracts between farmers, ranchers and landowners and oil and gas and mining companies. He was able to blow up private contracts where he did not want oil and gas or mining operations to occur.
- It is likely he will give environmental groups special control over the US Forest Service. His pattern is to feather his own nest and he would likely use the Forest Service to do that as he did in Colorado.

Response:

I appreciate the opportunity to respond to these issues. I'm enclosing for the Record, a signed response I prepared in advance of this hearing in order to respond specifically to the claims made in the correspondence you have received.

2) Question:

The U.S. Department of Agriculture (USDA) seems to be carefully tracking stimulus projects which are supporting the use of wood fiber for the production of biomass energy. However, despite receiving more than \$500 million for hazardous fuels reduction projects, it appears that almost none of these projects will produce wood fiber that can be used by the traditional sawmill and paper mill industries. Please tell me how many ARRA projects have produced merchantable wood fiber? How much volume in board feet or cubic feet did those produce? Please tell me whether ARRA funds have been used to pay for the non-merchantable component of stewardship contracts, allowing the commercial component to go forward in down timber markets?

Response:

While I have not been a part of the team at USDA implementing this program, I have been apprised of facts about the American Recovery and Reinvestment Act of 2009 (ARRA). The ARRA provided \$1.15 billion to the Forest Service for conservation work on the nation's forest with a focus on providing and retaining jobs. Of the total, Congress appropriated \$650 million for Capital Improvement and Maintenance (CIM) projects and \$500 million for Wildland Fire Management (WFM) projects. Of the \$500 million for Wildland Fire Management, Congress further directed \$250 million to be used on Federal lands and \$250 million on State and Private lands and up to \$50 million of the total funding may be used to make wood-to-energy grants to promote increased utilization of biomass from Federal, State, and Private lands.

Again, while I have not been part of the implementation team, I understand that the Forest Service treated 68,000 acres of the 393,000 acres projected in planned projects. If confirmed, I look forward to working on implementation of the ARRA, as it provides a wealth of opportunities for resources and economic growth. I will study this issue more closely and ensure that we are achieving the maximum benefits possible with the resources provided for this program.

3) Question:

Recently, Secretary Vilsack announced his vision for the role of USDA in managing public and private forests. His "all lands" approach suggests that USDA will take an active role in matters affecting private forests, including their participation in climate change and energy policies and their role in addressing environmental services, like clean water and air and providing wildlife habitat. Working forests are a significant part of the jurisdiction of this committee, and we want to make sure that any policies affecting working forests are developed with the full participation of private forest

owners and this committee. Will you fully involve private forest owners in the development of USDA policies on working forests? Will you fully involve this committee in any policies USDA develops on working forests? Will you commit to working with the committee to explore policy opportunities together that will promote the benefits of working forests?

Response:

I applaud Secretary Vilsack for articulating a new and clear vision for forestry. Water quality and related natural resource issues are important to me and I am enthusiastic at the prospect of joining the team at USDA to help guide implement this vision. Clearly, it is important to take a collaborative approach in the headwaters, tributaries and looking at all of the actions on the land and how those actions interact with water quality. Without question, this will mean engaging state and private partners because of what is happening in private woodlots and across multi-jurisdictional and lands.

If confirmed, I look forward to keeping the Committee fully informed about our efforts to sustain private forest lands. The position of Under Secretary for Natural Resources and Environment affords a tremendous opportunity to work with State Forestry Agencies, Tribes, and a diverse range of partners and stakeholders. I am enthused about the full range of programs that seek to address forest protection, restoration, and management needs across the landscape from urban open space to rural headwaters.

Senator Tom Harkin

1) **Question:**

The Food, Conservation, and Energy Act of 2008 (FCEA) reflects carefully balanced and integrated compromises. Among the most important decisions by Congress was the agreement to include some \$4 billion in additional funding for conservation programs over 10 years above budget baseline levels. The policies enacted and funded in the legislation are being effectively used, for example, in the recently-announced Mississippi River Basin Initiative, which makes extensive use of funding from the Environmental Quality Incentives Program (EQIP) and authority from the Cooperative Conservation Partnership Initiative.

Do you agree that in light of the significant demands and need for conservation on agricultural land it would be unwise to cut back on the funding committed to conservation in the FCEA?

Response:

There is increasing national attention directed to the state of this country's water, air, soil and plant and animal resources. Regional initiatives such as the Chesapeake Bay, the Mississippi River Basin Healthy Watersheds, and the Great Lakes Reinvestment Act, all serve to highlight the needs for conservation funding. I understand that the NRCS has seen continuing substantial backlogs of unfunded applications for EQIP, WHIP, FRPP, and AMA. Also, the new Conservation Stewardship program has a great deal of interest around the country. Despite the troubled economy, all mandatory programs, including the Conservation Security Program, have shown healthy sign-ups in FY09. All of these figures demonstrate the growing need for, and interest in, Farm Bill Conservation Programs by private landowners and conservation partners. If confirmed, I look forward to working on Farm Bill implementation and specifically identifying ways to best utilize and support the Conservation Title investments that the Farm Bill provides.

2) **Question:**

In recent audits by the Department of Agriculture Office of Inspector General of the Wetlands Reserve Program and the Conservation Security Program the OIG identified failure to ensure compliance with the program requirements. This problem traces back, in my view, to insufficient funding being allocated for Natural Resources Conservation Service technical assistance personnel and activities so that conservationists can carry out conservation programs, including necessary compliance checks. For instance, the number of acres enrolled in the Wetlands Reserve program has continued to increase, and therefore the cost of monitoring and enforcing WRP easements has continued to rise, but the technical assistance support funding allocated for the program has stayed relatively flat at around 5 percent of total WRP funding. Currently, WRP technical assistance cost for monitoring and enforcement are an estimated \$12 an acre, but allocated funding for these activities are only around \$6 an acre.

How will you ensure that sufficient funding is allocated to NRCS technical assistance personnel and activities so that conservation programs can be carried out and delivered to farmers and ranchers properly, and so that NRCS can fulfill its core responsibility to enforce the statutory regulatory requirements of programs?

Response:

I have been briefed in general terms regarding the issue you raised. NRCS is looking for ways to increase its efficiency; thereby freeing up staff time to do the kind of work referenced in your question. Without question, technical assistance resources are vital to achieving success on all of our natural resources goals. This is true in terms of taking an "all lands" approach. It is true in terms of applying the resources

needed to help quantify and verify greenhouse gas mitigation steps. And, it is certainly true of effective and accountable implementation of the Farm Bill.

But beyond that, I am also interested in supporting the basic conservation infrastructure, planning and assistance needed to assist landowners, even in cases where no cost share or governmental financial investment is involved. If confirmed, I look forward to assisting and helping to lead a new budget allocation process with a goal of funding the field conservation needs first so that as many financial resources as possible can be directed to funding technical assistance personnel.

Senator Max Baucus

1) **Question:**

Congratulations on your nomination to be Undersecretary for Natural Resources and the Environment for the Department of Agriculture. I am pleased that the President has chosen someone with your experience dealing with issues facing the forests, prairies and water resources of the West.

If confirmed, you will oversee programs and implement authorities that have a major impact on the economy and natural environment of my state. One authority the Forest Service has at its disposal is the ability to enter into stewardship contracts that enable it to trade logs and other goods to help carry out projects that reduce hazardous fuels, improve watersheds and other important forest management goals.

Stewardship contracting is very popular in Montana, helping form collaborative partnerships among diverse groups of forest users such as the wood products industry, the conservation community and sportsmen. Stewardship contracting also makes good economic sense for the Service. On one ranger district in my state, stewardship contracting enabled the ranger to perform nearly \$1 million of service work for which the district did not have appropriated funds.

While I am pleased that use of stewardship contracting is gradually increasing, I want the Forest Service to do much more. Since the Service was given broader contracting authority in 2003, it has completed only 34 contracts in the Northern Region. Most other regions have completed even fewer. I would like to know if you, as undersecretary, would work to substantially increase use of stewardship contracting, not only in my state, but across the nation. Does the Forest Service need any additional authorities to improve and increase the use of stewardship contracting and agreements?

Response:

If confirmed, I would explore the feasibility of increasing the use of stewardship contracting. This could become an important part of the US Forest Service's tool box to achieve restoration work. I understand that the Forest Service is currently looking at options to increase the use of stewardship contracting where appropriate, in pursuit of the Secretary's forest restoration goals. I also understand that Stewardship contracting authority is currently a temporary authority that will expire in 2013. If confirmed, I would look closely at this issue and seek to gauge whether broader use of this tool could also be facilitated by alleviating constraints associated with the current requirement to fully obligate (fund) the cancellation liability at the time of contract award.

2) **Question:**

Additionally, some non-profit groups have told me the Forest Service has been inflexible in determining matching requirements for stewardship agreements. The stewardship authority provides Forest Service and Bureau of Land Management personnel the same discretion in establishing matching requirements. Yet, the Forest Service requires a 20 percent match from non-profits, while the BLM requires no firm match. These non-profits can be valuable partners in stewardship projects and the Service should be more creative in evaluating their contributions. I would like to know if you will take steps to encourage non-profit participation in stewardship agreements.

Response:

It is my understanding that current Forest Service policy provides the Regional Forester discretion to reduce the level of the required match to as low as 5%. Current Forest Service policy also allows the match to be either in cash or in an "in kind" contribution. I understand that these are both recent policy changes that seek to address the concern expressed by the non-profit partners and ameliorate the constraint. If confirmed, I look forward to being more fully briefed on these topics and determining what further action, if any, might be warranted.

Senator Debbie Stabenow

1) **Question:**

What is your understanding of the authority given to USDA by section 1245 of the Farm Bill, and how do you foresee this authority being carried out over the next several years?

Response:

The statutory section that you have highlighted in your question, is one that I am enthusiastic to work on, if confirmed. This section of the 2008 Farm Bill, "Environmental Services Markets," is intended to aid development of market-based approaches for environmental goods and services. The provision requires the Secretary of Agriculture to establish technical guidelines for measuring environmental services from conservation and other land management activities. Specifically, I understand that the section requires the Secretary to develop:

- Standards, guidelines and procedures for measuring environmental services benefits;
- Protocols for reporting and verifying these benefits;
- A registry to collect, record, and maintain information on benefits measured.
- Involve stakeholders

If confirmed, I look forward to being briefed more thoroughly on the work of the Office of Ecosystem Services and Markets. I also look forward to working on this issue closely and promoting the utilization of market based conservation opportunities.

2) Question:

As Congress continues to debate climate legislation, what can USDA be doing now to develop methodologies and standards for GHG emission reductions in agricultural and forestry offset projects?

Response:

I am looking forward to the opportunity to work closely on the issue of Climate Change and greenhouse gas emission reductions. I share the views of Secretary Vilsack and the Administration that climate change mitigation provides a wealth of opportunities for agriculture and for foresters. If confirmed, I would work to better bolster and coordinate our ongoing research efforts – both within USDA and throughout the scientific community. Some of the work that must be furthered in this area includes developing practical methods for verifying the results of carbon offset land management activities. Research will continue to be needed to reduce the uncertainty that remains in quantifying the life cycle GHG emissions for some forestry practices, such as prescribed fire and others. I am also looking forward to exploring the work of the Forest Inventory and Analysis and helping to promote forest landowner participation in potential offset programs.

If confirmed, I would also like to build on the substantial progress made to date in providing opportunities to increase the utilization of biomass to generate renewable energy and offset the use of fossil fuels. I believe that further progress can be made

both in our standard programs, but also within special funding and authorities provided through the Recovery Act. I look forward to working with you and other Members of the Committee in this regard.

3) **Question:**

The President has committed to and Congress is ready to pass over \$400 million for Great Lakes Restoration projects. This funding will build upon the work that many Great Lakes stakeholders have been working to develop for over 5 years. Given that your position with USDA would oversee some of the largest federal conservation programs, how can USDA play a more vital role in Great Lakes restoration process?

Response:

The Great Lakes Restoration Initiative Action plan is a clear example of great potential for the federal government to make great strides in water quality improvements. Led by the Environmental Protection Agency, 15 different federal agencies worked together to make the Great Lakes restoration a priority. I understand that USDA has worked collaboratively to articulate the most significant ecosystem problems and to define efforts to address them.

Secretary Vilsack has articulated an overarching focus for USDA grounded in principals of sustainability and restoration not only for federal land under USDA jurisdiction but all lands. Within this framework, Great Lakes Restoration would be a key priority for me, if confirmed.

4) **Question:**

Should you be confirmed, how can USDA better collaborate with EPA to ensure land management programs are more successful in the future?

Response:

I believe that both NRCS and the Forest Service have a long history of collaborating with EPA on a number of issues such as source water protection, watershed restoration, air quality, smart growth and urban land use, and best management practices for protection of water quality. If confirmed, I would want to further that relationship, both personally with the leaders of EPA, but also to help establish a better working professional relationship between our agencies at all levels. I would want to work closely together as we mutually address emerging challenges around issues like air quality, wildland fire and smoke, and watershed management. The

Forest Service will continue to provide sound advice to EPA to assure that associated regulations achieve their intended purposes without unintended consequences.

Senator John Barrasso, M.D.

1) **Question:**

In Wyoming, where more than half of the state is public land, we are keenly aware of the U.S. Forest Service responsibility for management of its lands. Currently, we face an unprecedented bark beetle infestation that threatens our forests and communities. If confirmed, how will you address the following management challenges related to this infestation?

Response:

I know from my experiences in Colorado, extensive tree mortality from the bark beetle epidemic has been devastating my state as well as Wyoming and Montana. The area affected (nearly 8 million acres in 2008), the number of species of trees and beetles involved, and the diversity of ownerships has presented management challenges. Dense and homogeneous stands, combined with drought and warmer temperatures, have favored bark beetle population increases. If confirmed, I would work closely with this Committee to identify how resources of our agencies can be best applied to meeting these challenges. Or, if the authorities and resources we are currently working within cannot achieve the desired objectives, we will work collaboratively with you to determine how we can fill those gaps.

a. **Question:**

Programmatic funding for Regions 2 and 4 of the U.S. Forest Service has historically fallen well below need. These regions have been disproportionately deprived of management resources. How will you address the funding needs for management of the bark beetle outbreak throughout Regions 2 and 4?

Response:

From my experiences in Colorado, I understand that throughout much of the Rockies, lodgepole pine forests are experiencing a severe and widespread epidemic of mountain pine beetle. In addition, national forests in the west are experiencing numerous major wildland fires. I understand that the agency acknowledges the issues and management challenges created by these forest health challenges. The extent of bark beetle infestations, in particular, precludes widespread treatments and I am told that the Forest Service and State partners are focusing on treatments in high priority

areas, such as the wildland-urban interface, recreational areas, water sources and ecologically significant areas.

If confirmed, I can commit that I would closely examine the allocation of resources among regions for this purpose, and determine what further actions are needed to make our bark beetle mitigation and recovery efforts as effective as possible.

b. Question:

U.S. Forest Service local managers are facing an unprecedented forest health event. What management authorities do you believe need to be adjusted to meet the challenges posed by this infestation? Specifically, how will the Department, under your direction, address each of those needs?

Response:

If confirmed, I would work hard and focus resources on the topic that you have raised in this question. In dealing with the suppression of the current infestation and prevention activities to reduce the susceptibility to future outbreaks, I would work with you and other Members of Congress to determine what, if any, additional resources or authorities might be needed.

c. Question:

Bark beetle infestation spreads beyond political boundaries. We must take a regional approach to management of our forests. Specifically, how will you promote regional action to regional management of the bark beetle infestation?

Response:

I understand that the Forest Service Region 2 has established the Bark Beetle Incident Management Team (IMT) to address the impacts of the infestation, and find ways to increase efficiencies to treat more acres with current funding. I am told that this IMT is coordinating activities among the various agencies affected to reduce hazardous fuels, capture the commercial value of trees to the maximum extent possible (i.e., timber sales & stewardship contracts), spraying trees in campgrounds, and the removal of hazardous trees in developed recreation areas, along roads and trails.

But the issue and approach raised in your question is an excellent one. It is important for leaders to look well beyond existing boundaries and job descriptions to deal with important priorities and emerging crises. If confirmed, I assure you that I will work

to apply resources to dealing with this problem in a manner that takes a holistic approach to the entire area affected.

2) Question:

Our forest products industry partners are struggling in this economy. Many of the industry partners who historically helped manage federal forests are no longer in business. This increases the burden on federal agencies and weakens our local communities. If confirmed, how will you promote business friendly practices at U.S. Forest Service to sustain and regrow the American forest products industry?

Response:

The issue raised in this question is one that I look forward to working on, if confirmed. The national economy and with it the forest products market has declined over the past several years to an extent that many timber sales throughout the country are no longer economic to harvest. This drastic decline in forest products markets is now in its third year and is greater in magnitude than a similar decline in the early 1980's. Timber sale purchasers are faced with great economic losses on existing timber sales and, in many cases, can be faced with bankruptcy if forced to log under existing contract terms. Secretary Vilsack has made it a priority to help rural Americans and build future economic opportunities. I see forests and specifically private forest products as a central part of this effort. Further, to achieve our forest restoration goals, we need an infrastructure to maximize investments. I look forward to getting in place at the Department, if confirmed, and working on an overall strategy with my counterparts within the Rural Development mission area and other colleagues to realize more opportunities for forest products and build the infrastructure needed for a restoration economy.

3) Question:

U.S. Forest Service recently proposed spending \$2.8 million of wildland fire management funding under PL 111-5, the "American Recovery and Reinvestment Act," in Washington, D.C. Of the 5.5 million acres of wildlands nationwide, as defined by the National Interagency Fire Center, Washington, D.C. has none. There is no need for wildland fire management funding in the District of Columbia. While the kind of State and Private Forestry projects proposed for Washington, D.C. have merit, wildland fire management funding should not be diverted for this purpose. U.S. Forest Service must prioritize its limited resources to meet its basic responsibilities. Wyoming communities depend upon adequate management of U.S. Forest Service lands and we demand that the agency get its priorities straight. If confirmed, how will you direct U.S. Forest Service to prioritize its wildland fire management budget in the future?

Response:

I have not been part of the team at USDA implementing the Recovery Act, although I am enthusiastic to assist USDA in this effort. The legislation contains so many opportunities for the nation, including helping natural resources and making our country more resilient to future conservation challenges.

I have only been briefed on general issues that you raise in your question but if confirmed, I look forward to working with our professional program staff to gain a full understanding of the program funding that has been provided to date and gauge the relative merits and priorities for this funding going forward.

4) Question:

If confirmed, will you join Secretary of Interior Ken Salazar in supporting west-wide good neighbor authority, that would allow BLM and U.S. Forest Service to enter cooperative agreements with the states to implement forest health projects?

Response:

Yes, and I further believe national good neighbor authority is warranted to help address forest health issues that challenge eastern forests across diverse land ownerships. In these times of limited resources, it is important to leverage workforce and technical capacities, all within existing environmental laws and regulations.

5) Question:

U.S. Forest Service renewal of grazing permits is continually backlogged. This is a detriment to public land ranchers and to the day-to-day operation of the U.S. Forest Service range management. If confirmed, specifically how will you address the permit backlog and improve the agency's handling of grazing permit renewals?

Response:

I am told that the Forest Service has developed a schedule, and is vigorously working towards completion of NEPA for all grazing allotments. If confirmed, I will work with the Forest Service and Congress to find the most expeditious means to complete the required NEPA to continue the use of National Forest System grazing allotments.

Honorable Saxby Chambliss
U.S. Senator
416 Russell Senate Office Building
Washington, DC 20510

Dear Senator Chambliss:

Thank you for the opportunity to respond to the e-mail you received from Mr. Jerry Peavy of Griffin, GA, concerning my nomination as Under Secretary at USDA.

The e-mail is an amalgam of vague, unspecified charges from unnamed sources about alleged actions I have taken in my capacity as Director of the Colorado Natural Resources Department. The claims made are untrue and unfairly malign me and my colleagues at the Department of Natural Resources.

As Director, I oversee Colorado's energy, water, wildlife, parks, and state lands programs. I also serve as Co-Chairman of the Governor's Forest Health Advisory Committee. The Department of Natural Resources has approximately nine divisions, 2,000 employees, and a \$200 million plus budget. Our work is very diverse and we seek to balance many competing concerns. Resource issues are often contentious and it is our job to reconcile as many of these competing interests/issues as possible while protecting the State's economy and environment.

Colorado is blessed with an unusually diverse and vibrant economy. Agriculture, tourism, hunting and fishing, energy, manufacturing, high technology, and government sectors are all important cogs in our economic engine. The State also has some of America's most beautiful, high quality environments including wilderness and roadless areas, national and state parks, valleys and grasslands. Blending the economic goals of our State with our desire to protect our environment is a primary goal of my department.

Reading between the lines of Mr. Peavy's e-mail, he appears to be complaining about the recent legislation and rule making concerning Colorado's oil and gas development. By way of background, since 1999, Colorado has experienced an eightfold increase in natural gas permits issued each year by the Oil & Gas Commission. Production of this resource often takes place in rural, relatively undeveloped areas with high scenic value. Often, these areas that have strong tourist, hunting and fishing, agriculture, retirement and second home economies. Because of the newness and pace of the oil and gas development, multiple concerns were raised by residents regarding protection of drinking and irrigation

water, impacts to wildlife, public health and safety issues, air quality, and general quality of life considerations.

Our Legislature passed a bill in early 2007 that expanded the Oil and Gas Commission to include not only industry members, but also citizens representing farming, mineral property owners, wildlife and local government. A new statutory mission was given to the Commission to foster oil and gas production in a manner consistent with the protection of the State's environment, wildlife, and public health and welfare. The Division of Wildlife and Health Department are now required to consult with the Oil and Gas Commission regarding wildlife and environment matters.

Rule-making followed the legislation. It was the most transparent, open and comprehensive rule-making in the State's history. Extending over 18 months, all parties (approximately 85) were given every opportunity to provide input to the Oil & Gas Commission. The Commission heard from industry, local governments, agriculture, sportsmen, homebuilders, royalty owners, property owners, and environmental groups. Every group had access and input into the process. No special access was given to any group nor did any group have more opportunity for input than anyone else. The process was open and transparent. Property rights were respected. The final rule-making was balanced and fair; it was unanimously supported by the Oil & Gas Commission including its 3 industry representatives.

Subsequently the Colorado Legislature reviewed and approved the rules, as required by Colorado law, and the Governor thereafter signed the rule-making package into law. Major newspapers throughout Colorado, including the Denver Post, Grand Junction Sentinel, and Durango Herald, supported the rules as balanced, moderate, and workable. Recently, representatives of the oil & gas industry have also pointed to the Colorado rules as a responsible way of addressing certain issues without the need for federal intervention in similar areas.

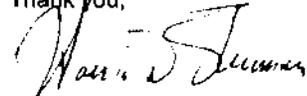
The Oil & Gas Commission is now implementing the new regulatory system. It works closely with the Division of Wildlife and Department of Health. As part of the process, the Division of Wildlife will meet periodically with operators to discuss mitigation of wildlife impacts and work to formulate agreements that can be proposed to the Oil and Gas Commission. The Division of Wildlife's views are recommendations only and it cannot dictate wildlife terms to any operator. Under the new system, landowners must agree to wildlife specific terms and conditions before they can become part of any permit.

Recently, Colorado, like other parts of the United States, has experienced a slowdown in gas production. This slowdown is a result of the drop in natural gas prices, the severe credit crunch, and the fact that Colorado's export pipelines are at capacity. Governor Ritter and I have repeatedly emphasized that Colorado's

natural gas industry is essential to the State's economy and can play a central role in dealing with the nation's climate change challenges. There is no reason that this industry cannot thrive while at the same time being respectful and compatible with the State's environment, public health and safety, and our wildlife resources.

If I am confirmed, I will bring a balanced approach to the Under Secretary's position. Recreation, timber, mining, oil and gas, grazing, and other economic activities have an important place on our national forest lands. These resources can be utilized in a fashion that is consistent with protection of wilderness and roadless areas, conservation, and restoration activities within these forest lands. My door is always open to any group or individual who wishes to meet and discuss these issues.

Thank you,

A handwritten signature in black ink, appearing to read "Harris D. Sherman". The signature is written in a cursive style with a large initial "H".

HARRIS D. SHERMAN

**Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Commissioner Jill Sommers
October 6, 2009**

Senator Maria Cantwell

1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?

Yes, I believe that speculation can affect the price of commodity futures. Hedging, the taking of a position in the futures market opposite the position held in the cash market to minimize the risk of loss from an adverse price change, may also affect futures prices. While hedgers trade primarily to manage risk they also tend to bring a view to the market about where prices may be heading. In essence, futures prices are a consensus of the opinions of all who enter the market. The futures price of a commodity is linked to its cash price through the delivery process. As a result, futures and cash prices tend to move together. So, to the extent that speculation or hedging affects futures prices, they may also affect cash prices.

2. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?

I believe the recommendations that are included in Chairman Gensler's letter add significant improvements to Treasury's OTC proposal and are intended to enhance the CFTC's ability to implement the much needed comprehensive financial market reforms.

3. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?

I believe that appropriate position limits need to be set consistently across all markets in order to effectively address the issue of excessive speculation.

4. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

The concept release the Commission published in March asked for comment on eliminating the bona fide hedge exemption for certain swap dealers and creating a new limited risk management exemption. Commission staff is in the process of analyzing the comments received. In addition, the Commission held three days of hearings in July and August and heard from a number of different markets participants regarding the application of position limits and exemptions. This is a complex issue but I believe a possible solution would enable the Commission to grant exemptions to only those market participants that can demonstrate a commercial risk.

5. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade.

During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?

Yes.

6. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the "recklessness" standard instead of the current "specific intent" standard, how would this improve the Commission's ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?

Under current law, to prove manipulation the Commission must establish that the accused: (1) had the ability to affect market prices; (2) specifically intended to do so; (3) created an artificial price; and (4) caused the artificial price. In addition to its general antimanipulation authority, the CEA grants the Commission authority to prosecute specific manipulative practices such as the false reporting of transactions or market information, exceeding position limits, wash sales, accommodation trades, and fictitious sales.

The CFTC has filed a total of 57 enforcement actions alleging manipulation and/or attempted manipulation. Of those cases, 55 were resolved in the agency's favor against some or all of the defendants through settlement, default, or administrative hearings (one of which was reversed by the Commission on appeal), one was lost after trial, one was won after trial in federal court (currently on appeal), and one remains pending. The civil monetary penalties imposed by the Commission from these cases total \$617,132,000.

The "recklessness" standard employed by the SEC, the FERC, and the FTC was a subject of discussion at joint meetings on market regulation harmonization held by the CFTC and the SEC on September 2 and 3, 2009. Some panelists observed that the types of manipulative schemes that occur in the securities markets are often different than the manipulative practices that occur in the commodities markets, with "pump and dump" cases being common in the securities markets as opposed to corners or squeezes in the commodities markets. The Commission's Office of General Counsel has expressed concern that the SEC's "recklessness" standard may not be sufficient to cover market power cases involving squeezes and corners in the commodities markets where the manipulator's conduct does not involve fraud or deception.

A recent case decided in the United States District Court for the Southern District of Texas, United States v. Radley, [cite], raises other concerns regarding the Commission's manipulation authority. In Radley the court ruled that the manipulation standard under Commodity Exchange Act failed to provide the defendants with sufficient notice that their conduct was illegal because it fails to define "artificial price." This decision could have far reaching implications for the Commission's enforcement program if other courts choose to follow its reasoning.

I believe that a statutory clarification of the Commission's manipulation authority would be prudent and that the precise nature of the clarification must be carefully studied and analyzed.

7. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the "Treasury Proposal to Regulate OTC Derivatives" and "CFTC Legislative Language" as it relates to this proposal. In reviewing GMAC membership as posted on the Commission's website, it appears that the committee's membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

Yes.

Senator Max Baucus

1. Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

If the CFTC is granted oversight over carbon allowances and related derivatives markets under a cap-and-trade system for carbon emissions, the CFTC would include these contracts in its ongoing oversight program for regulated U.S. futures and options markets. A key goal of this program is to detect and deter market manipulation and abusive trading practices. Effective oversight will likely help attract liquidity by building confidence in these emerging markets.

Senator Charles E. Grassley

1. This question is just for Ms. Sommers and Mr. O'Malia. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?

Transparency is the cornerstone of a well functioning regulatory system. Regulators must have sufficient reliable information from the marketplace in order to ensure that the exchanges under their oversight are operating in an open and competitive manner, free from manipulative influences or other price distortions. The markets must also be transparent to market participants and the public.

The CFTC has taken a number of steps in the past year to bring greater transparency to the U.S. commodity futures and options markets. In accordance with recommendations contained in a September 2008 Staff Report on Commodity Swap Dealers and Index Traders, as of September 4, 2009, the Commission began publishing a new disaggregated Commitments of Traders (COT) report to shed light on the changing composition of large traders in the markets. Prior to the new disaggregated report, the Commission separated large

trader data into two categories: (1) commercial; and (2) noncommercial. The new report separates large trader data into four categories: (1) Producer/Merchant/Processor/User; (2) Swap Dealers; (3) Managed Money; and (4) Other Reportables. The Commission intends to also release in the near future three years of historical data for the new report.

In addition to the new disaggregated COT reports, the Commission is working to create a new COT report for all the financial markets to improve the transparency of those markets. The CFTC is also working on improvements to the agency's Form 40 and other methodologies to improve the accuracy of trader classifications.

Also beginning on September 4, 2009, the CFTC began releasing expanded index investment data detailing the notional values of index investment positions and the equivalent number of futures contracts for all U.S. markets with more than \$0.5 billion of reported net notional value in any one quarter. The new index investment data is more comprehensive than index data previously released by the Commission in that it covers more U.S. markets (not just selected agricultural markets) and includes both the gross long and gross short positions. The Commission intends to release this data on a quarterly basis with the goal of releasing it on a weekly basis in the future.

Upon announcing the new disaggregated COT reports and Index Investment Data, the Commission sought public comment on any possible further enhancements. I am hopeful that as the CFTC continues to receive additional data from markets and suggestions from the public on how to improve the collection and dissemination of this information, we will continue to refine and enhance the data we release to the public.

2. In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?

According to our economists, the CFTC's large trader and index investment data seem to show that speculative activity did not decrease significantly during this period of price collapse. I cannot determine the precise cause of the decline, but I suspect that many factors contributed, both global and domestic. Most oil market analysts argue that the extraordinary run up in price was caused by expectations

of insufficient supply due to world wide economic growth. These analysts typically explain that high prices eventually gave way to weak demand as the global economy moved into the current recession. Whatever the cause of the volatility of oil prices over the last two years, I support regulatory reform efforts that would subject oil trading across all markets to robust regulatory standards.

Senator Pat Roberts

1. What is your definition of "systemic risk?" Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a "systemic risk" as some are suggesting?

In my view, systemic risk is the risk that the default of, or other financial difficulty experienced by one or more market participants, results in the dislocation or distress of the entire financial market. I do not believe that every OTC market participant or product has the potential to create, or does in fact create, systemic risk. Congress may want to consider that a very important distinction would be where the line is drawn between those market participants and products that are systemically important and those that are not.

2. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

In the specific example that you have outlined, I believe it is important to ensure that all OTC derivatives market participants are well capitalized to engage in their respective market activities and that capital requirements are set on the basis of the risk they pose to the system. This is the underlying policy of the CFTC's risk-based regulatory capital regime and it has served us well thus far. As Congress reviews the very important issues surrounding the implications of insufficient capital requirements there may be alternatives that could accomplish similar objectives. I am hopeful that any solutions that are considered will avoid requirements that create significant barriers to entry.

Senator Amy Klobuchar

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. In a recent speech and in your testimony, you noted that the CFTC has to prove that someone "specifically intended" to manipulate prices. As a former prosecutor, I know chasing criminals isn't easy, but this standard would seem to make it even more difficult to go after criminals. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?

Having the resources to hire and retain experienced enforcement staff and develop sophisticated information technology that can detect manipulative schemes and other trading abuses is the single greatest tool we could ask for to ensure the effectiveness of our enforcement efforts.

2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Our Division of Enforcement does an excellent job and I will continue to fully support all of its efforts to investigate and prosecute any market manipulation or abusive trading practices in the markets we regulate.

Chairman Blanche Lincoln

On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

The cotton investigation was a very important undertaking for the Commission and our Division of Enforcement. I expect to see something publically released outlining the results of the investigation in the near future.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Mr. Kenneth Albert Spearman
September 30, 2009

Senator Chuck Grassley

1. As you know many in the agriculture sector and in particular livestock producers are struggling to stay afloat. On top of the tough economic times they are facing, now it seems as if credit is also drying up. Many banks have looked at their agricultural portfolio as a liability and that in turn has added another burden to our producers. What do you see as the role of the Farm Credit Administration in working with the farm credit system member banks to help these producers through this economically uncertain time?

Answer:

The Farm Credit System serves to provide creditworthy farmers, ranchers, their cooperatives, and others with access to dependable and competitive credit. This is the System's primary mission whether the agricultural economy is prosperous or during an economic downturn – similar to what is being experienced today by many in the dairy and livestock sectors.

The Farm Credit Administration's mission is to ensure the System's safety and soundness while also promulgating rules and regulations so that the System meets its Congressional mission. As a FCA Board Member, I will strive to meet the agency's goals of System safety and soundness while being mindful of the System's mission to serve the credit needs of America's farmers and ranchers in good times as well as not so good times. And, be especially aware and sensitive to the hardships that farmers and ranchers may endure during cyclical downturns and strive to give them my utmost consideration.

Senator Tom Harkin

1. Mr. Spearman, you serve as an outside board member for the AgFirst Farm Credit Bank, and this experience clearly provides you with valuable background and knowledge for serving on the board of the Farm Credit Administration (FCA). AgFirst is one of the institutions of the Farm Credit System (FCS), all of which you will be tasked with overseeing as a member of the FCA Board. To be sure, you have pledged that you will if confirmed resign from the AgFirst board and comply with the applicable conflict of interest and ethics requirements.

As a regulator you will be tasked with ensuring the safety and soundness of the FCS and also ensuring that lending by FCS institutions complies with the statutory objectives, requirements, and limitations of the Farm Credit Act of 1971, as amended. The recent turmoil in the global financial system obviously underscores the crucial importance of enforcing prudent safety and soundness standards. At the same time, as a board member of the FCA, you will have a responsibility to help facilitate FCS institutions in making affordable credit available to borrowers who are eligible under the Act.

In the light of your previous position on the board of a FCS institution, please describe carefully the approach you will take and any specific steps involved to make sure that in your new position as a member of the board of the FCA you will be truly objective, even-handed, and free of pre-determined conclusions in handling the various questions that will come before you.

Answer:

As an independently appointed board member of AgFirst, my role was to serve as an external, independent point of view to the Board of Directors. As a controller and auditor of Florida's Natural Growers, my position was to provide to the business cooperative an independent and objective appraisal of its financials and to ensure that it complied with applicable accounting practices.

I believe my education, training and 28 years of experience in accounting and auditing will serve me well as a FCA Board Member. Furthermore, I believe my time as an outside Director on the AgFirst Board has given me a great appreciation for the vital role the Farm Credit System plays in agricultural lending.

If confirmed as a FCA Board Member, my role is to be an arms-length regulator of the System's safety and soundness so that it may continue to serve its congressional mission to meet the needs of America's farmers and ranchers with access to competitive credit.

My career as an auditor has required my objectivity and independence which I believe will serve me well as a FCA Board Member. I come to this new endeavor with an open mind, no preconceived positions, and a clear understanding of my new role. Lastly, I will strive to be fair and thoughtful in all issues that come before the FCA.



FOIA Office

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5105
Facsimile: (202) 418-5124
www.cftc.gov

March 4, 2016

RE: 15-00200-FOIA
Seeking a copy of each response to a
Question for the Record (QFR)
provided to Congress by the CFTC.
(Date Range for Record Search: From
01/01/2012 To 06/13/2014)

This is in response to your request dated June 13, 2014, under the Freedom of Information Act, seeking access to a copy of each response to a Question for the Record (QFR) provided to Congress by the CFTC from January 1, 2009 to June 13, 2014. In an email to me dated February 4, 2016, you clarified and confirmed limiting the timeframe of your request to January 1, 2012 to June 13, 2014. In accordance with the FOIA and agency policy, we have searched our records, as of June 13, 2014, the date we received your request in our FOIA office.

We have located 135 responsive records. You are granted full access to the responsive records, which are enclosed.

If you are not satisfied with this response to your request, you may appeal by writing to Freedom of Information Act Appeal, Office of the General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 8th Floor, 1155 21st Street, N.W., Washington, D.C. 20581, within 30 days of the date of this letter. Please enclose a copy of your original request and a copy of this response.

If you have any questions about the way we handled your request, or about our FOIA regulations or procedures, please contact Justin Wilkes at (202) 418-5876.

Sincerely,

Joan E. Fina
Assistant General Counsel

**NOMINATION HEARING TO CONSIDER
GARY GENSLE TO BE CHAIRMAN OF THE CFTC**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
FEBRUARY 25, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

54-564 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

| | |
|------------------------------------|---------------------------|
| PATRICK J. LEAHY, Vermont | SAXBY CHAMBLISS, Georgia |
| KENT CONRAD, North Dakota | RICHARD G. LUGAR, Indiana |
| MAX BAUCUS, Montana | THAD COCHRAN, Mississippi |
| BLANCHE L. LINCOLN, Arkansas | MITCH McCONNELL, Kentucky |
| DEBBIE A. STABENOW, Michigan | PAT ROBERTS, Kansas |
| E. BENJAMIN NELSON, Nebraska | MIKE JOHANNIS, Nebraska |
| SHERROD BROWN, Ohio | CHARLES E. GRASSLEY, Iowa |
| ROBERT P. CASEY, Jr., Pennsylvania | JOHN THUNE, South Dakota |
| AMY KLOBUCHAR, Minnesota | |
| KIRSTEN GILLIBRAND, New York | |
| MICHAEL BENNET, Colorado | |

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|---|------|
| HEARING(S): | |
| Nomination Hearing to Consider Gary Gensler to be Chairman of the CFTC .. | 1 |

Wednesday, February 25, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|---|---|
| Harkin, Hon. Tom, U.S. Senator from the State of Iowa | 1 |
| Cardin, Hon. Benjamin L., U.S. Senator from the State of Maryland | 6 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 2 |
| Lugar, Hon. Richard G., U.S. Senator from the State of Indiana | 3 |
| Mikulski, Hon. Barbara A., U.S. Senator from the State of Maryland | 4 |
| Sarbanes, Hon. Paul, former U.S. Senator from the State of Maryland | 7 |

Panel I

| | |
|--|---|
| Gensler, Gary, Nominee to be Chairman and Commissioner of the Commodity Futures Trading Commission | 9 |
|--|---|

APPENDIX

| | |
|---|-----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 40 |
| Gensler, Gary | 43 |
| DOCUMENTS SUBMITTED FOR THE RECORD: | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Gary Gensler | 46 |
| Various organizations, letters of endorsement for Gary Gensler | 70 |
| QUESTION AND ANSWER: | |
| Harkin, Hon. Tom: | |
| Written questions for Gary Gensler | 74 |
| Brown, Hon. Sherrod: | |
| Written questions for Gary Gensler | 77 |
| Casey, Hon. Bob: | |
| Written questions for Gary Gensler | 78 |
| Grassley, Hon. Charles E.: | |
| Written questions for Gary Gensler | 79 |
| Nelson, Hon. Ben: | |
| Written questions for Gary Gensler | 81 |
| Roberts, Hon. Pat: | |
| Written questions for Gary Gensler | 82 |
| Stabenow, Hon. Debbie: | |
| Written questions for Gary Gensler | 84 |
| Gensler, Gary: | |
| Written response to questions from Hon. Maria Cantwell | 85 |
| Written response to questions from Hon. Dianne Feinstein | 98 |
| Written response to questions from Hon. Carl Levin | 108 |

**NOMINATION HEARING TO CONSIDER
GARY GENSLER TO BE CHAIRMAN OF THE
CFTC**

Wednesday, February 25, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 2:40 p.m., in room SD-106, Dirksen Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Conrad, Stabenow, Nelson, Klobuchar, Chambliss, Lugar, Roberts, Grassley, and Thune.

**STATEMENT OF HON. TOM HARKIN, U.S. SENATOR FROM THE
STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**

Chairman HARKIN. The Senate Committee on Agriculture, Nutrition, and Forestry will come to order. I know we just had a vote. We are waiting on some Senators to arrive. Senator Chambliss said he would be a few minutes late and to go ahead and proceed.

Good afternoon, and we thank you all for joining us today. We meet this afternoon to consider the nomination of Mr. Gary Gensler to serve as the Chairman of the Commodity Futures Trading Commission. As many of you know, Mr. Gensler is not new to public service. He served as Assistant Secretary for Financial Markets, and later as Under Secretary for Domestic Finance at the Department of Treasury. He was at Treasury about 3 years, so he brings this experience to this CFTC position.

This nomination comes at a very challenging time. Since the CFTC was created 35 years ago, it has never faced more daunting market challenges than those that the next Chairman and Commissioners will face. Our financial markets are still unstable, and the physical commodities of energy, agriculture and metals have experienced dramatic price movements and volatility.

Again and again, actions in our futures markets have caused some havoc across our country and economy. I thought about this, and in principle are supposed to provide some stability and certainty and not to create havoc.

One year ago this weekend, we had an experience in the cotton market. Speculative funds ran up the prices of the cotton futures market at a time when there were record surpluses of cotton and not very much demand. So there was a ton of money, speculative money, going into the futures markets that had absolutely nothing

to do with supply and demand. It served no constructive economic purpose except maybe to make some people wealthy.

The markets for other agricultural commodities experienced similar disruptions for wheat, corn, and soybeans. They rose to record levels last year. Country elevators that had offered producers forward contracts and then hedged their positions on the Chicago Board of Trade struggled to find the cash resources to meet margin calls. Users of commodities from bakers to pork producers to ethanol facilities, suddenly realized that the price they would have to pay for the most critical inputs was double the price they had paid just a couple months before.

Prices in the energy sector also shot up to unprecedented levels last summer. Energy users from airlines to commuters to farmers struggled with higher fuel costs. So in places like my State of Iowa, people are wondering; is Washington really asleep at the switch? Do we understand the disruption and damage caused by ineffective and inadequate oversight and regulation?

Last night, President Obama urged Congress to move quickly on legislation that will finally reform our outdated regulatory system. He called for tough new common-sense rules of the road so that our financial market rewards drive innovation and punishes short-cuts and abuse. So it is our responsibility to rise to the President's challenge.

This Committee and the Commodity Futures Trading Commission have a profound responsibility to craft and implement tough-minded regulatory reforms. Last month, I reintroduced the Derivatives Trading Integrity Act. "Integrity" is a synonym for honesty. The bill would require that all futures contracts trade on a regulated exchange, including all derivatives contracts. I came to that position after our hearing in October on derivatives. Exchange-traded contracts are subject to a level of transparency and oversight that is just not possible in over-the-counter markets.

The best-intentioned and most brilliantly crafted legislation will be only as effective as the regulators who implement it. We must have an unflinching determination on the part of the Commodity Futures Trading Commission to restore integrity to these important markets.

That is why the position of Chairman of the CFTC is so critical. And that is why this Committee must gain assurance that the nominee before us is prepared to provide strong leadership at the CFTC, to work with this Committee to develop solutions to ensure that markets are open, transparent, free of excessive speculation, and that all trades clear. We need to know if Mr. Gensler will be committed to repairing the damage from abuses and mistakes of the past and ensuring that they are never repeated.

With that, I will hold the record open at this point for a statement by Senator Chambliss. I would ask if Senator Lugar or others would have opening statements that they would care to make at this time.

Senator Chambliss, for an opening statement.

**STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM
THE STATE OF GEORGIA**

Senator CHAMBLISS. Mr. Chairman, thank you.

I will submit my opening statement for the record, and let me just echo, Mr. Gensler, we welcome you to the Committee, and we welcome your girls to the Committee.

We have had the opportunity to visit and obviously I know your background. We look forward to continuing a dialog on the issues that we know face this industry and look forward to working with you down the road with respect to making sure that we continue to provide financial investors in this country the type of regulation that is fair, reasonable, and will ensure safety and security in the market.

So thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss.

Senator Lugar.

**STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR
FROM THE STATE OF INDIANA**

Senator LUGAR. Mr. Chairman, let me just add that I appreciated especially the hearing you conducted in which we participated last October. I felt that was an educational experience for us and for the American people, and I appreciate the progress that has occurred at CFTC subsequent to that hearing. People were able to do some things administratively.

But I would just simply chime in to say that as a very junior Senator, Senator Leahy and I sat at the end of the table and were assigned by Chairman Herman Talmadge the responsibility of oversight of the CFTC, because apparently no one else on the Committee understood what he was doing and no one really wanted to find out. So we have had some parental responsibilities in subsequent years, and I appreciate very much the evolution. But this is a pivotal moment today as we take a look at a new chairmanship, a new era, the regulatory suggestions you have made and other members likewise. And so I look forward to the hearing.

Chairman HARKIN. Thank you very much, Senator Lugar.

Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman. Unfortunately, I have to leave, so I am going to make a couple of statements and leave open a question which I hope Mr. Gensler can respond back to us in writing.

You have outlined very clearly and succinctly the problems that we face today with the volatility that we have experienced in the markets. I hope we have the opportunity to see where the weaknesses are and what fixes are necessary. Credit derivatives, obviously regular commodities, physical commodities, need to be bound by certain rules. But it is important that whatever regulations are put in place does not constitute strangulation of the commodities in the whole.

I think the CFTC must preserve the price discovery aspect of the markets and risk management hedging benefits that it provides. It needs to regulate with a focus on what has become more and more important, the system risk, and not just look for bad actors in the situation.

I think the thing that interests me most is the need that the CFTC should be proactive and try to anticipate matters that pose a threat to systemic risk than always be reacting. I know it is a

very challenging thing to be able to predict and to anticipate without some market experience to guide you as to what needs to be done. But waiting until the systemic risk is so big or the fire is beyond the capability of being put out is not a course of action that we would like to see happen again.

The question that I really have of Mr. Gensler, should he be confirmed, is—we proposed that the CFTC issued—they issued a report, and we came back and we asked that the report's recommendation of the review of, quote, whether to eliminate the bonafide hedge exemption for swap dealers and replace it with a new risk management exemption subject to certain conditions that we suggested that be done. And my question is do you know whether that has been done or, if it has not, whether it will be done. And if you can just get back to me on that, that certainly will satisfy me.

But thank you very much for your willingness to serve, and I look forward to my two colleagues giving a great introduction of you. Thank you.

Chairman HARKIN. Thank you, Senator Nelson.

Senator Grassley.

Senator GRASSLEY. Yes, thank you very much, Mr. Chairman. Obviously, we need to congratulate Mr. Gensler. I think we ought to also thank Walt and Michael for their acting chairmanship and the hard work that they put into the work of the Commission. I think our last year has shown that more aggressive activity on the part of the CFTC is really needed.

This is a year when we are going to have to decide to a greater extent the appropriate role of regulation of speculators to a greater extent than we have in the past. We are going to have to decide if we are serious about giving the CFTC the resources it needs to do its job effectively. And that is what new leadership is all about, I hope, and, of course, the work of this Committee as well.

So I am not going to be able to stay around here to ask questions, but I told Mr. Gensler that I would be submitting about eight questions for answer in writing. So I thank you, Mr. Chairman, for the privilege of making a statement, and I will put my entire statement in the record.

Chairman HARKIN. Thank you very much, Senator Grassley.

We have a distinguished colleague and a distinguished former colleague, and I will recognize them in order for purposes of introduction. Senator Mikulski from the great State of Maryland, welcome to the Agriculture Committee.

**STATEMENT OF HON. BARBARA A. MIKULSKI, U.S. SENATOR
FROM THE STATE OF MARYLAND**

Senator MIKULSKI. Thank you very much, Mr. Chairman, and also Senator Cardin, who is currently presiding, will also be joining us, and it shows the enthusiastic support that Mr. Gensler enjoys from the Maryland delegation.

First of all, in terms of the Commodity Futures Trading Commission, we know how important this Commission is. But as Senator Lugar so aptly said, it is often little understood or little noted, unless there is a crisis in the markets. And last summer, also the

whole issue of commodities and the futures trading just exploded in our community and our media and in our marketplace.

I had bakers lined up throughout in my office and out in the community wondering how they were going to buy rye and wheat and so on to keep their small and medium-sized businesses going. We were talking about the high price of gasoline. We were talking about something called the "London loophole" and how we needed to close that.

So the whole issue of commodities we are seeing not only as something that was primarily an Agriculture Committee issue, but an American issue and how it affects our community.

There is grave concern whether there was adequate oversight, adequate regulation, and what we needed to do. Well, I think now we are on the path in the right direction. But whatever the rules of the road, whatever Congress chooses to do, we need to have the right person in charge of the CFTC. That is why I enthusiastically endorse and introduce Gary Gensler to the Committee to be the Chairman of the Commodity Futures Trading Commission. We know his work when he was in the Senate. We know his work in the Clinton administration, and also he is and continues to be a community leader in Maryland.

I know him to be a man of principle and great intelligence. He has a deep understanding of finance, both domestic and international, and how to turn that knowledge into workable policies that will protect the interests of our country and the interests of our consumer.

During this time of great financial turmoil and uncertainty, we need someone with these skills, this background and experience, and these values to lead the Commission. So I enthusiastically support him for this important position.

When you look at his resume, we know that he worked hard at Treasury and received the Alexander Hamilton Award, the highest award that the Department can give. He worked with our colleague Senator Sarbanes in terms of fashioning a response to not only the Enron scandal, but how we could make corporate America more responsible, the Sarbanes-Oxley bill.

He has worked as a top economic adviser both in our own government and on Wall Street. He is also a strong community leader. Whether he has been on the board of Johns Hopkins University or whether he has helped the Community Enterprise Foundation be able to provide affordable housing, Gary has always been someone who has given of his own time and, I might add, of his own dime.

And just speaking as a woman, I watched him and my heart went out to him when his own beloved wife, Francesca, struggled with breast cancer. He had to be a father; he had to be a mother; he had to be a devoted husband. He was always at his wife's side, and at the same time tending to his children.

Someone who knows what sorrow is and has to go through that, and also what it means to his family, and then while he was doing that, to stay civically engaged while at the same time watching the marketplace. I think we have someone who brings talent, who brings dedication, and who brings values. I think the Committee would be well served in approving his nomination.

Chairman HARKIN. Thank you very much, Senator Mikulski, for that very strong supportive statement.

Now our distinguished former colleague, Senator Sarbanes. Welcome back.

Senator SARBANES. Mr. Chairman, thank you very much, and I appreciate your courtesy in allowing me to appear. It is a risky proposition on your part because former Senators do not get much of a chance to speak, and there is always a danger they will abuse the microphone when the opportunity presents itself. But I know you want to move along.

Actually, I will withhold and defer to Ben and keep it in—I am out of office, and they are in office, and I respect the difference very much. Do you want to go ahead?

Senator CARDIN. I usually yield to my constituents, and Senator Sarbanes is my constituent. But let me—

[Laughter.]

Chairman HARKIN. Senator Cardin.

**STATEMENT OF HON. BENJAMIN L. CARDIN, U.S. SENATOR
FROM THE STATE OF MARYLAND**

Senator CARDIN. Mr. Chairman, let me thank you for the courtesy of just a few remarks with regard to Gary Gensler. He is a friend. He is a person I have known for many years. I deeply respect his intellect, his integrity, his financial knowledge, and his commitment to public service. And I join Senator Mikulski and Senator Sarbanes in recommending him for confirmation.

Gary has a tremendous depth and breadth of knowledge on financial issues. He was in the Department of Treasury from 1997 to 2001, Assistant Secretary for Financial Markets and Under Secretary for Domestic Finance. He was a senior adviser to both Secretary Rubin and Secretary Summers.

He received the Treasury Department's highest award, the Alexander Hamilton Award. He was an adviser to a very distinguished member of the U.S. Senate, Chairman Sarbanes, when Paul chaired the Banking Committee and helped Senator Sarbanes when we passed the Sarbanes-Oxley legislation, which regulated corporate America—very important legislation on corporate responsibility—we could use more of that today—and accounting and security laws.

So Gary is well prepared through his experience to take on this very important responsibility as Chair of the Commodity Futures Trading Commission. But I want to tell you just one more thing about him. His background in the community, the type of volunteer activities that he has committed himself to, in helping educational institutions and helping health care institutions and helping those who are disadvantaged. It tells you a lot more about him. He is a person committed to our community.

I will tell you one more thing about him. He has participated in nine marathons, and if he is confirmed, helping repair our economy will be his tenth marathon, and I am sure he will be just as determined to bring us to a successful goal, and I encourage his confirmation.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Cardin.

Now Senator Sarbanes.

**STATEMENT OF HON. PAUL SARBANES, FORMER U.S.
SENATOR FROM THE STATE OF MARYLAND**

Senator SARBANES. Well, thank you very much, Mr. Chairman.

First of all, I want to just underscore something that both Senator Mikulski and Senator Cardin said, and that is the very substantial, positive contribution that Gary Gensler has made in the Baltimore community through his civic involvement. If we talk about being a good citizen and sort of participating and meeting your responsibilities, this is a prime example of someone who has done that. And it has been of enormous benefit to our community, and we are all deeply indebted to him for it.

He has been in a sense a star from the beginning. He was a *summa cum laude* graduate from the Wharton School of Business at the University of Pennsylvania, first a BA and then an MBA. He then went to work in the financial industry where he had extensive experience, and then he was in the Treasury for, I think, close to 4 years. He then wrote a book about mutual funds, and then I was fortunate enough—I was then Chairman of the Banking Committee, and we were confronted with the Enron situation.

Enron was the seventh largest company in the country. It was reporting record profits in the first part of 2001, first quarter, second quarter, 20-percent increase in profits each quarter. By October, they were restating their earnings. November, they restated them again. December, they declared bankruptcy. The largest bankruptcy in U.S. history up to that point. It was subsequently eclipsed by WorldCom in June of 2002.

The Committee, which I then chaired, was charged with the responsibility of addressing the situation, and one of the things we did which made an enormous difference, as it turned out, was to get Gary Gensler to come and work with us as a senior adviser to the Chairman. And his contribution was enormous.

He was integrally involved in shaping the legislation, which, of course, dealt with oversight of the accounting industry, the reform of corporate governance, and investor protection measures. And let me just quickly outline for the Committee the qualities he brought to that work, which I think will stand all of us in good stead should he be confirmed as Chairman of the CFTC.

First of all, he thinks comprehensively in terms of what is necessary to make the financial system work. So he has a breadth and depth of vision which is somewhat rare, but which is extremely important, particularly when you are trying to deal with a situation where the system is breaking—seems to be breaking down and it needs to be, as it were, restructured and put back together again.

He is extremely smart. I indicated his past accomplishments. Nowadays, people are around developing more and more complex instruments all the time, and you have got to have someone there who can not only stay with them every step of the way, but can be ahead of them, can anticipate what is coming and seek to address it.

He knows the markets well, and he is very committed to ensuring that the markets work honestly and fairly. And the markets are an important part of the workings of our economic system. But

if they do not work honestly and fairly, they will drive the economic system down, and all of us will pay a very high price for that.

He is very hard-working. He is not ideological. He is pragmatic. He is a good listener. He seeks practical solutions, seeks to develop constructive and positive approaches. He is firm and fair. And he brings excellent judgment and very strong leadership skills. I think he will be very effective in heading the agency and imparting a sense of mission to the employees in terms of what needs to be done.

I want to say to the members of the Committee, I have absolute confidence in his integrity and in his judgment, and I think it is an opportunity for the country to put his superior understanding of financial markets and his extensive experience to work on behalf of the American people. I can assure you he will be a fierce enemy of fraud and manipulation, that he will find it, root it out, and also try to make the systemic changes that will contribute to it not recurring again, which is, of course, very important. We can go after the bad actors, but we want to have a system in place that precludes the bad actors from coming along in the first place.

Gary Gensler has a very, very deep commitment to the public interest. I have had occasion to talk to him at length about his feeling for the country, his own opportunities in life, and the need to make the system work fairly for all.

And, finally, Mr. Chairman, let me just say he appreciates, I think, the role of the Congress and the workings of our political system. Sometimes you get these people in the executive branch, and they have difficulty understanding there is a legislative branch that plays a very important role. Gary Gensler I think clearly understands the role of the Congress. I think he is sensitive to it. He appreciates it is an important partner. And I want to say to the Committee I think he will be an absolutely first-rate partner for the Congress as you move to address the economic challenges which you, Mr. Chairman, and the other members of the Committee outlined at the beginning of this hearing.

Thank you again for the chance to come and be with you.

Chairman HARKIN. Well, thank you very much, Senator Sarbanes. Good to see you back, and I am sure we do not have any questions for all of you, but I just would say for the record that Mr. Gensler is indeed very fortunate to have three such well-respected and well-liked advocates for his position as the two sitting Senators and the previous Senator from the State of Maryland. Thank you all very much for being here.

Now I would like to call Mr. Gensler to the witness table.

Mr. Gensler, before you take your seat, if you would rise, we have an oath that we have to administer.

Mr. Gensler, do you swear to tell the truth, the whole truth, and nothing but the truth?

Mr. GENSLER. I do, Mr. Chairman.

Chairman HARKIN. And, Mr. Gensler, do you agree that, if confirmed, you will appear before any duly constituted committee of the Congress if asked?

Mr. GENSLER. I do, Mr. Chairman.

Chairman HARKIN. Thank you very much, Mr. Gensler. Please have a seat.

Mr. Gensler, welcome to the Committee. My congratulations on your nomination by the President, and we have your written statement. It will be made a part of the record in its entirety, and the floor is yours. You may proceed as you so desire.

TESTIMONY OF GARY GENSLER, NOMINEE TO BE CHAIRMAN AND COMMISSIONER OF THE COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Chairman Harkin, Ranking Member Chambliss, members of the Committee, thank you for the opportunity to appear here before you today. I am honored to be President Obama's nominee to be Chairman of the Commodity Futures Trading Commission at this critical time in the commodities markets, and for our Nation.

As a champion of the public's interest—for farmers, consumers, small businesses—the CFTC plays an essential role in our financial regulatory system and affects the lives of all Americans. And I firmly believe that strong, intelligent regulation with aggressive enforcement is what our economy needs and benefits the public.

The current economic crisis clearly has shown, though, that our financial and regulatory systems have failed the American public terribly. Those of us who have spent our time, our professional lives, around markets have to approach the current crisis with humility following such broad failures. We have learned the limits of our ability to foresee how markets may evolve. We have learned the importance of being candid with the American public about the risks we face and that we must be unceasingly vigilant to address these risks. We have also learned that there is no substitute for strong, independent regulation, that we must bring transparency and accountability throughout the system, and we must always err on the side of protecting the American public.

These are the lessons I draw from what has transpired this past decade. And, if confirmed, I pledge to this Committee and to the Congress that I will not forget these lessons.

We must repair our regulatory system by enacting much needed reforms that promote transparency, fairness, and safety.

If confirmed, I will fight hard on four essential priorities for reforming the commodities markets and our financial system.

First, the CFTC must vigorously fulfill its mandates: enforcing existing laws, promoting market integrity, preventing against fraud and manipulation, and guarding against excessive speculation. I will work tirelessly to ensure that the Commission leaves no stone unturned, ferreting out and putting to a stop activities and practices that hurt the American public.

I also look forward to working with Congress to provide the adequate resources for this agency which I believe currently lacks the sufficient funds to do even its current mission, let alone the missions I think it needs to take on.

Second, I believe that increased speculation in energy and agricultural products hurts American farmers and consumers and businesses. I do not have any doubt about that. A transparent and consistent playing field for all physical commodity futures should be

the foundation of our regulations. Position limits must be applied consistently across all markets, across all trading platforms, and exemption to them must be limited and well defined.

Third, we must now urgently develop a broad regulatory regime for over-the-counter derivatives. Standardized products need to be brought into mandated clearing and mandated exchanges. Beyond this, I believe the institutions themselves—the derivative dealers that make the markets in derivatives—need to have direct regulation under Federal statute, capital rules, business conduct reporting, and regulations need to be developed for customized swaps and for credit default swaps given their unique nature.

And, fourth, I believe the CFTC must work with Congress and other regulators around the globe to ensure that failures of the regulatory and financial systems, failures that the American people public has taken such a toll, never happen again. Now, this will not be easy. These are complex financial markets, and markets are irreversibly linked. But we will have to work with our global partners to make sure that around the world we have the same rules that we have here. This is the only way that Americans can really be protected.

Mr. Chairman, Ranking Member Chambliss, I am a proud believer in financial reform, tough regulation enforcement. I have been privileged to have had broad exposure to financial markets, here and in Asia, in public service and on Wall Street, as an investor advocate, and as a Government official.

And my experience has taught me the importance of having a strong working relationship with Congress. I appreciate Senator Sarbanes' comments on that. In these transformational times, I do believe we have a unique opportunity working together to bring bold and necessary reform forward. We must, though, take this opportunity to ensure we deliver on the expectations that all Americans have for us.

I would like to close by saying how much the support of my family—my three daughters—means to me, and the great sacrifices they will make if I am so honored to serve. My eldest, Anna, is a freshman at college and could not be here. My two other daughters, Lee and Isabel, if it would be appropriate, I would just like to introduce to the Committee.

Chairman HARKIN. Please introduce them.

Mr. GENSLER. This is Isabel, my youngest, who is 12, and then my daughter Lee, who is 17, who are here with us today.

Chairman HARKIN. Welcome to the Committee.

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, members of the Committee, I look forward to taking your questions.

[The prepared statement of Mr. Gensler can be found on page 43 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Gensler.

Mr. Gensler, in confirming nominees and moving their nominations forward, I like to know about their background and history and where they are now, their present views and outlook. Obviously, you have had experience, you have served in a previous administration. I would like to cover some of that with you as a way of examining where we were in the late 1990's and where we are today regarding issues under CFTCS jurisdiction.

On May the 18th, 1999, you testified before the House Agriculture Committee's Subcommittee covering risk management. In response to questioning by our distinguished ranking member, when he was a member of the House Agriculture Committee, you said you "positively, unambiguously" agreed with Mr. Larry Summers in his testimony to the Senate Agriculture Committee opposing additional regulation of the institutional over-the-counter derivatives market.

You went on to refer to the "vibrancy and importance" of the global over-the-counter derivatives market.

Here is a direct quotation. You said quote, "That large and vibrant market is part of, I believe, the American success. And we should recognize that and put the burden on those who are suggesting changes and further regulation, put the burden on them before we tamper on some of the successes of this marketplace for the economy."

Well, that is quite a resounding, unqualified, and categorical statement, no second thoughts or ambiguity.

Ms. Brooksley Born, who was about to leave as the Chairperson of the CFTC, had advocated strenuously over the previous few years, including before this Committee, that the risk of these over-the-counter derivatives needed to be evaluated and appropriately regulated.

However, you were part of the team arguing—and you can correct me if I am wrong on that—for a statutory enactment to take away all CFTC regulatory power over these over-the-counter derivatives. According to the Washington Post of October 15th, 2008, this team was really quite dismissive of Ms. Born, to the point of it kind of becoming personal at that time. But I do not need to go into that.

But this team was quite direct in advocating that these be exempted from CFTC regulation.

Mr. Gensler, what was your own personal role in dealing with Ms. Born during the time she was chair of the CFTC? Did you attend any meetings during that period of time in 1998 or 1999 or did you have any telephone calls or communications over that period of time with her? What was the nature of those interactions, and did you have any advice for her at that time?

Mr. GENSLER. Mr. Chairman, thank you for your question.

First, may I say, looking back now it is clear to me that all of us that were involved at the time—and certainly myself—should have done more to protect the American public through aggressive regulation, comprehensive regulation. We should have fought harder for some of the things that we raised with Congress at the time, whether that be regulating derivative dealers or keeping the oil and metals markets consistently regulated with the corn and wheat and soybean markets. These were things we recommended and we should have fought harder for.

I clearly look back on some things outside the jurisdiction of this Committee that I should have fought harder for, guarding against predatory lending practices.

I believe there are many things that at the time that we could not foresee, or did not see. They were just dots on the landscape,

as you, I believe, and other Senators here commented. And we have to do a far better job seeing that which is out on the horizon.

You asked specifically about meetings with Chairman Born and I recall working with her, working with her as a staff member at Treasury. I was an Assistant Secretary working on a report on long-term capital management and the after effects of the collapse of long-term capital management where there was a joint report put together in the spring of 1999.

During those earlier periods of 1998, when there was different views of the Treasury, the Federal Reserve, and the SEC from the CFTC, Ms. Born raised very good questions but I, in fact, at the time was recused because it did relate to a particular matter of my former employer. I had been at the full, big set piece President's Working Group meetings, as would be customary for the Assistant Secretary to attend, along with other staff of Treasury.

Chairman HARKIN. Well, Mr. Gensler, that is a very straightforward answer and I appreciate that. So would you say that your views and your thoughts on this have evolved and changed over the intervening years, looking back at what has happened in the last several years?

Mr. GENSLER. Mr. Chairman, I very much would say that my views have evolved. There is so much that has happened in the marketplace as electronic trading facilities, even that our exchanges now are public and for-profit enterprises and back then were not for-profit and public. And the financial crisis itself, to me, goes to the heart of some of the assumptions that I think collectively all of the Federal agencies and even Congress at the time grappled with.

I believe now it is just so important that we bring the whole over-the-counter derivatives marketplace on the market, into exchanges, as you do. I share that goal. And to also bring that over-the-counter derivatives marketplace onto centralized clearing.

I, frankly, though do not think that is enough. I also think we need regulation of the institutions, that Congress would actually have a statutory regime for derivative dealers, somewhat like we have for banks, where you have capital rules which address the excess leverage, have business conduct rules to make sure there is not fraud and manipulation in the sales practices. And then, of course, last and very importantly, reporting rules. These dealers—there is about 15 or 20 around the globe that make up 99 percent of the market for over-the-counter derivatives.

So I have come to believe strongly we need both, the market side, clearing and exchanges for the standardized products, the derivative dealers clearly regulated, all the information coming in.

Chairman HARKIN. I am going to follow that up in my second round because I want to ask about this whole idea of having some derivatives that are not on a regulated exchange. I will get to that.

In my reading, my memory but also my reading of that period of time from 1998 through about 2000, was that the President's Working Group was very forceful in their position that these OTC derivatives should be exempted from the CFTC. As I said, to the point one time where it also got personal with Ms. Born. I remember that.

And in my reading of it, about that, from various sources, it appears, of course, that you have some very strong personalities there. You have Mr. Greenspan, who was driving this, quite frankly. And he is a very forceful personality. He was driving this.

Then you have Mr. Summers. He is no shrinking violet, as we all know. He was driving this, also.

Then you have Mr. Rubin there, also. So you have a very forceful group.

CFTC was sort of shunted aside. Well, Mr. Gensler, should you get this position as the Chairman of the CFTC, you will be on the President's Working Group. And I needn't remind you that you will not be working for Mr. Geithner. You may be a friend of his; that is fine. You will not be working for him. You do not work for Mr. Summers. You do not work for Mr. Bernanke. You are the chairman of an independent regulatory agency. You do not even work for the President. You are chairman of an independent regulatory agency.

And as such, your views and your positions that you have should be that of a chairman of an independent agency. And one should not be reticent in advocating a position even to the extent that some of the other forceful personalities may not agree, if you get my point.

I just want some assurances from you that you will be that independent voice. Like I said, I am not asking you to sever friendships or the like. I am saying the mindset, the mindset of the Chairman of the CFTC cannot be working for Mr. Summers or Mr. Bernanke or Mr. Geithner or anybody else. And that you will bring that independent mindset to the President's Working Group.

Mr. GENSLER. Mr. Chairman, I thank you for that question. I think being Chairman of the CFTC is an independent regulatory agency. The commitment I give this Committee and to the American public that I will bring that independence. If I have a concern or thought about the regulatory protections that the American public needs, I will absolutely share it as one of the President's advisors, as part of the President's Working Group, with the President and senior members of his economic team.

But if we cannot reach any consensus and I believe something, I am going to bring it to this Committee, I am going to bring it to the American public. There is a real difference, in my mind, of being an Assistant Secretary of Treasury and being the chairman of an independent regulator.

I appreciate that when the President asked me—then President-Elect Obama—to be his nominee in December and we had a chance to chat, that was what he understood and that is what I understood, that I will certainly be advising the President. It would be a great honor to advise him on regulatory reform and all that we need.

But that which is at the core of my beliefs, that we have to bring the entire over-the-counter derivatives marketplace into a regulatory regime, these two pieces that I have talked about, these two big pieces I have talked about and the goals that we share, they have heard me saying this straight through since December 18th and they are going to keep hearing me say it. And I make that commitment to you, sir.

Chairman HARKIN. Thank you very much, Mr. Gensler. I will return to the issue of derivatives and trading on exchanges during the second round.

With that, I would of course yield to our distinguished ranking member, Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Mr. Gensler, in your statement you state, and I quote, "The current economic crisis clearly has shown that our financial and regulatory systems have failed the American people terribly."

I know you are very familiar with the workings of the CFTC. Surely you have followed the markets over the last several years since your direct involvement at Treasury. Is there anywhere that you think, or any particular instance you think where CFTC falls into that category of having failed the American people terribly?

Mr. GENSLER. Senator Chambliss, I think that the great failures are largely beyond the CFTC. But even in this area, the CFTC is, by Congress, that Act in 2000 that the Chairman referred to, asserted that they are an agency that has to look after systemic risk as well. And we clearly have had a systemic failure.

Second, though the CFTC, I do not think, has the tools to look after that much, I do believe that we have had speculation that contributed and hurt farmers and consumers and all Americans.

And if confirmed, I would fight hard to make sure that we have the resources and that we can bring what is needed to be borne to these markets within the current authorities at the CFTC.

Senator CHAMBLISS. With the current authority that is out there and the current resources that you are familiar with, do you think there is anything that the CFTC did not do that they should have done relative to this systemic risk issue that you are talking about?

Mr. GENSLER. Well, again, when the failure is so broad and complete, Senator, I just think all regulators have to look into themselves and say what could we have done differently? I do that personally, in terms of my own record.

I think that the CFTC has aggressively fought and tried to enforce fraud and manipulation in other areas. But if confirmed, I would certainly want to take a look at all of the individual hedge exemptions that are currently in place, some for 20 years or so. I think it is time to look back and see whether those exemptions are still appropriate, given the current times.

There are processes that the CFTC uses to allow for markets or individuals to take action sometimes that are not brought up to the full Commission level, and I think we need to do that, as well.

So these might sound like they are around the edges of a big financial calamity, but I think every agency needs to take a look to see what can we do better and what can we do more.

Senator CHAMBLISS. You and I talked about the potential for an SEC/CFTC merger that a lot of folks are advocating and have been advocating. And I noticed you are quoted, and I hope this is an accurate quote, "CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important task with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake."

I want to say that on the vital function of the CFTC, certainly you and I are very much in accord there. There has been much discussion about merging these two agencies, as well as the creation of a new systemic risk regulator to oversee all Federal financial regulators.

Personally, I have great reservation about bringing these two regulatory bodies together, as I expressed to you. For one, the SEC's performance in regulating their current portfolio has been less than stellar. And second, the CFTC uses principle-based regulation that has proven an effective approach to regulating commodity futures. It is difficult for me to see how welding these two regulators together will serve Americans well.

First, are you a proponent of the CFTC's principle-based regulatory approach? And if so will you, as Chairman of the CFTC, work to preserve this regulatory approach, as regulatory reforms and reshuffling of hureaucratic boxes are contemplated and proposed? And second, what problems could you see arising from an SEC/CFTC merger?

Mr. GENSLER. Senator Chambliss, I appreciated the time we spent in your office. I think we may have talked about this as well at that moment, too.

As I said, and that was an accurate quote, I think this financial crisis brings to bear so many other problems other than, as you say, the boxes. The CFTC was formed in 1974, hut really it was formed back in 1922 to protect the interest of—at that time—grain merchants and farmers so that they could appropriately and reliably hedge their risk in the future about their corn and wheat and then later soybean. And of course, we have added many other products to it.

I think that is fundamentally very different than what the SEC does. They are both market regulators. They both need to be strong on enforcement and anti-fraud and anti-manipulation, and look out for the public.

But at the core, the CFTC's mission about protecting farmers and merchants and later oil and metals, and though it has been expanded to financial products and it is critical to get the over-the-counter derivatives marketplace correct as well, is sort of around a different set of mission and goal than that which is the SEC.

I think both very vitally important. And as you rightfully point out, one of them principles-hased which, as Chairman of the CFTC, I would support and make sure it works. And if it did not work, I would be back here readily to work with Congress to see if we needed to fix something. And the Securities and Exchange Commission has another approach.

Senator CHAMBLISS. The 2000 Modernization Act was a very complicated piece of legislation that you were involved with back then, as were a number of us. We thought we were doing the right thing and I think we did absolutely the right thing by allowing the market to expand and putting more flexibility out there. As a result we saw these markets grow in a tremendous way. I think all of that has been healthy for the economy.

Obviously, as you alluded to, over the last 10 years—or well, 9 years we have seen major changes in the industry. We have seen

very volatile prices from time to time which can be attributed to any number of issues.

But my question to you is looking back at the 2000 Act, and knowing what you knew then, is there any recommendation that you think was made that we did not follow that should have been followed that we ought to think about now? Or do you think that act worked the way that all of us intended for it to at that time?

Mr. GENSLER. Well, I believe, looking back now, knowing what we know now, there are two areas that we did raise then but we should have fought harder for, I personally felt—thank you, Senator—should have fought harder for.

One was the concept of regulating the dealers themselves, the brokers, the voice brokers or derivative dealers that are making markets. We all know their names. I will not name them here, but the large financial institutions.

We recommended that. In some cases, they were the affiliates of the broker-dealers. But one of the big lessons out of AIG, the insurance company that failed, they had an unregulated dealer in the derivatives business. And now, in that case, it was \$450 billion in size. In that case, it was largely credit default swaps. But it was also unregulated. There was no, not the New York State Insurance Commissioner, nor any Federal regulation about its capital, its business conduct, its reporting. I think we need to put that in place.

Second, at the time the President's Working Group did suggest and recommend that oil and metals and cotton and wheat all have a consistent regulatory regime. We were unable to achieve that, working with the various committees in Congress in working that through.

But I think that is a good foundation. I still think that is the right foundation, that if something has finite supply and is more easily manipulated, that we should think of consistent regulation and make sure that we get that in.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss.

Senator LUGAR.

Senator LUGAR. Thank you, Mr. Chairman.

You have just mentioned, Mr. Gensler, the ideal of having the agricultural commodities but likewise, a broader group together. Certainly in testimony that we heard in October and before many advisors, even to pension funds and to college endowment funds, suggested a grouping of commodities which included corn and soybeans but also metals and oil and these combinations of commodities that serve those interests well for a period of time.

But it did lead to an interesting question with regard to regulation of them, and it is a discussion that we had at the time of the reauthorization of CFTC a while back which, without going into who was for and against, the problem of the regulation of oil, for example, or of various other energy products, was fiercely resisted by some Senators, by some witnesses, by some members of the Administration at the time, as I recall.

I mention that now because I really want your judgment as to what should be the scope of the CFTC? We think about the agricultural scene, that seems fairly clear. It has never been quite that

clear with regards to other commodities, as they are thought of generally.

What sort of scope do you envision as ideal, in terms of a regulatory regime?

Mr. GENSLER. Senator, I thank you for the question and I thank you for having—we had a good meeting together on these subjects.

I think that the Commodity Futures Trading Commission currently has exclusive jurisdiction from Congress to regulate the futures markets. And it has proven well, as Senator Chambliss said, though in the midst of a crisis everybody has to look within. It has proven well in regulating over these 35 years the futures markets.

I believe that if we are able to bring over-the-counter derivatives into centralized clearing, into exchanges for these products, that the CFTC is best situated with expertise on the derivatives marketplace, if appropriately funded I must add. But I think they are best situated amongst the Federal regulators for these authorities.

Senator LUGAR. Now the appropriately funded point which you touched upon in your opening remarks, and which has often been touched upon by the leadership of the Commission, just has not been occurring. There is not an understanding I think, perhaps, of the scope of what this means if you are to take in all of the different types of derivative contracts and various other situations.

From the beginning will you be able to give the Committee and work with us in terms of how many people you actually need or what sort of facilities are required to achieve something which the American people clearly want at this point?

Mr. GENSLER. Senator Lugar, I look forward, if confirmed, working with you and the Committee on that. I know under its current authorities the CFTC has just under 500 people. This is the same size it was in 1974.

Senator LUGAR. Yes.

Mr. GENSLER. So in 35 years, when the markets have grown more than 50-fold—again, markets have grown 50-fold, the agency is the same size. That is either efficiency or well, or it is underfunded. And maybe it is some of both, but I think it is underfunded.

It was 600 people just a few years ago. The enforcement arm had 150 lawyers, it is now only 110 lawyers, just to enforce the laws currently in place.

I believe the Agency has put a request in, and I am a private citizen but I was able to read this letter in the last few days, to get back up to 690 people. That gives you a sense of what they believe right now they need.

Senator LUGAR. I think it is probably incumbent upon us, but you if confirmed, to gain greater recognition for what the CFTC does. I think it has always remained in the shadows. But no longer. We have a financial crisis that still goes on.

Let me add one further thought, as you are thinking about the budgets. I have no idea what the result will be of our debates on energy resources, climate change. But let us say that a cap and trade system was established in this country in which there was really a very conspicuous and very expensive market for carbon.

I ask sort of in advance what your judgment would be as to whether the CFTC should be the agency that regulates huge sums

that are likely to be involved if a very serious cap and trade situation involving all of our industries, utility, so forth, was to come about?

Mr. GENSLER. Senator Lugar, I believe under the current statutory authorities that the CFTC does have that oversight, and there is a very small cap and trade market now I am told, regional market, that they have some oversight.

Senator LUGAR. Yes.

Mr. GENSLER. If that were to grow into a national market, he listed on an exchange or in other ways, the CFTC, I have been told in my early investigation, does have that authority. But I would certainly look forward to working with Congress if we need to put more of that into statute and address that specifically.

Senator LUGAR. Let me just ask as a personal inquiry, I have become a member of the Chicago Climate Exchange, largely as a demonstration that farmers who have hardwood trees and have proper measurement and so forth are sequestering carbon in their trees. And each year we have an update of how much more is there.

So on the website of the Chicago Climate Exchange, every day there is a quote for their price of a ton of carbon. It is \$1.95 today. It was up to \$7 at one point during the year.

Similar situations in Europe, however, have had quotes of anywhere from \$20 to \$50 per ton, depending on the Kyoto Protocol and how seriously some countries looked at this.

I mention this because there is, as you say, a modest attempt being made by people in Chicago, who also are working with the Europeans in this. And it may come to pass that the Congress debates this issue but puts it aside, as was the case last year.

But if we do not put it aside, this is going to be a very, very large set of problems and sums of money and implications for something well beyond agriculture or speculators in commodities. And that is why I wanted to try to establish who is responsible. And your judgment, and I agree with it, is that it is the CFTC.

But having the personnel, the regulations, the rest of it for this is sort of a quantum leap and is the type of thing which hopefully we will not look back in a hearing 10 years later and say why did we have no vision, no preparation, and no people.

Mr. GENSLER. Right. And Senator, I think you raise a very good point. The Commodity Futures Trading Commission has the best experience and background and current authorities regulating the futures markets.

But just as it does also work with the Department of Agriculture that has the best authorities and expertise on agriculture and the cash markets and so forth. So there is some shared protection of the American public between the Department of Agriculture and the CFTC in corn and wheat and other products, where the CFTC is focused on the futures.

There may well be multiple agencies in a cap and trade situation where the CFTC brings its expertise to protect the American public in the futures markets and other agencies bring their expertise to protect the public in other regards.

Senator LUGAR. Thank you.

Chairman HARKIN. Thank you, Senator Lugar.

Senator Stabenow.

Senator STABENOW. Thank you very much, Mr. Chairman.

First of all, welcome and I look forward to supporting your nomination.

Mr. GENSLER. Thank you, Senator.

Senator STABENOW. Is this microphone on? It is not working. Well, I am going to move over here, just a second. We will see if this one works.

OK, that is working, and I am not Senator Conrad.

Welcome again, and I will say for the record, with the microphone on, I look forward to supporting your nomination on the floor and to working with you.

I wanted to follow up with Senator Lugar, I think, what Senator Lugar was speaking about, the engines of cap and trade, which I think is such an important new area for us to focus on. President Obama spoke about it last night. We know that there is a lot of work being done, important work, being done to craft the right kind of balance for moving forward to tackle this issue, which I hope we will do.

And some believe this will create the largest derivative market in the world. So there are a number of questions that I have in terms of how we approach this. It is a real opportunity, I think, to design a transparent, efficient, carbon market that builds on the practices for market regulation that we have.

So I am wondering what you believe the lessons are that we have learned from other financial markets that would guide us, guide Congress and Federal regulators as we design a new carbon market?

Mr. GENSLER. Senator, first let me thank you for the support and confidence you have in me in this nomination, and that means a great deal to me.

As I indicated, the carbon markets and the cap and trade markets may grow. The CFTC does have expertise in terms of the futures markets. And though I have not studied these issues in any depth, let me just mention a couple of things.

I think that it is important, just as in other futures markets, to make sure that we have a transparent marketplace. So if there is a design of a contract, as there is design of contracts in corn and wheat and oil and so forth, design of contracts that there is some transparency and there is a marketplace where it trades, there the public can see and corporations can see that marketplace and have the benefit of that transparency. And that there really are protections, just as there are in other futures, from fraud and manipulation.

But there may be things that are specific to this market that I, if confirmed, would look forward to working with you and your staff and this committee to better understand and better advise you as you go forward.

Senator STABENOW. Thank you.

This may be something, as well, that you have not focused on specifically regarding carbon. But there is another issue related to that which relates to bonafide hedgers and what is a bonafide hedger in this context. And I would be interested in knowing if you have any thoughts on a definition or what the CFTC and the Con-

gress should do relative to this issue when we think about the nascent carbon market.

Mr. GENSLER. Senator, I think that all of the markets that the CFTC has oversight for, futures markets and hopefully these other over-the-counter derivatives, where there is something of finite supply, it is susceptible, that underlying product is susceptible to both manipulation, corners—what is called corners and squeezes. I am old enough to remember when the Hunt brothers cornered the silver market. I know the lack of hair, but I remember that.

And I am not familiar enough with the carbon markets, but I think that is probably a market that would fall into this category which is susceptible to some finite supply.

And also, the position limits are critical to protect against excess speculation. Hedgers need the benefit of speculators on the other side. We have had, for 130-plus years, contracts in the futures market and hedgers want somebody on the other side to take a risk. But there is a burden if it gets so excessive, and we saw that volatility in the last several years.

So I think as it relates to this new market, the lessons of guarding against manipulation, guarding against excessive speculation would inform me, as Chairman if confirmed, and quite possibly inform Congress as to thinking about a regime in the carbon market, as well.

Senator STABENOW. Thank you. I look forward to working with you on this issue. We have a number of different discussions we need to have that relate to regulating carbon, how this is going to be done in a transparent way, how there is accountability, how we—again, as you indicated, make sure that we are doing everything we can to deal with speculation in the marketplace driving up costs and so on.

So I think there is a very important opportunity and role going forward for the CFTC in this whole discussion, and what I hope will end up being a strategy for us to be able to address the issue of carbon and cap and trade.

Mr. GENSLER. Senator, if confirmed, I look forward to working with you on that.

Senator STABENOW. Thank you.

Chairman HARKIN. Thank you very much, Senator Stabenow.

Mr. Gensler, I had this chart prepared here. No, I am not Senator Conrad.

[Laughter.]

Chairman HARKIN. He sits right there. That is an inside joke referring to Senator Conrad's use of charts.

But this is the oil market from 1997, here is 2007, and here is the price spike of last year coming back down here to about \$40, maybe a little bit less than \$40 a barrel right now, somewhere in that neighborhood. So the consumers see this and they suspect something is wrong with this big spike. There really wasn't less oil. In fact, if anything, we were beginning to see the situation improve in Iraq, and Iraq has significant oil reserves. So it really wasn't a lack of a supply.

So if these wild price swings are not a function of normal market factors, how is that explained to the public? As Chairman of the

CFTC, how would you explain something like this to the public that happened last year in oil? How would you explain that?

Mr. GENSLER. Mr. Chairman, I think that we had an asset bubble in the oil markets, an asset bubble even in other commodity markets. To the American public, I would say, as we saw—

Chairman HARKIN. Explain that asset bubble as it regards this.

Mr. GENSLER. Well, similar to in the housing market, but driven by different factors, but just as the housing market, housing prices went up beyond what one might have said was the underlying cost to build the homes and so forth. In this marketplace, I believe that we had a great many people come to the conclusion that it is another asset class. The stock market is someplace you can invest. Maybe the bond market is someplace you can invest. Now the commodity markets is a third place one might invest to diversify risk, and there are great theories of diversification and theories I generally believe in.

But that risk diversification led some investors to try to invest in commodities and I think over this period, just before the run-up, but over the period from 2004 to 2007, that some statistics that I saw, that increase of outside investors, and I have said publicly and I will say again here I believe that investors that were investing as an asset class, whether they were index investors or hedge funds or other financial investors around the globe, not just here, had the perception that this price was just going to keep going up so that the—they were wrong. They were terribly wrong. But as a factor in that, the American public was hurt. I mean, it was terribly hurt by this speculative bubble.

Chairman HARKIN. So I could substitute speculators for the word “investors.” You use the word “investors,” but they were speculators. They were speculating on this market continuing to go up all the time.

Mr. GENSLER. That is true, like some people speculated on home values or some people speculated on real estate or other things.

Chairman HARKIN. This is something that I have wrestled with since I first came here in 1975 to the House Agriculture Committee and that is the role of speculators. The term speculator has a bad connotation. So what is the proper role for a speculator in a market? I don't care whether it is oil, it can be grains, it can be metals. What is the proper role? Is it beneficial? And how do you explain to the consuming public, most of whom, if you ask them should speculators be driven from the market, would say yes—nine out of ten, I bet, would say that—so how do you explain, what is the beneficial role of speculators?

Mr. GENSLER. I think at the history and the core of the futures markets, going back to the 1870's, in fact, when a farmer wanted to have a reliable price for corn or wheat that they might want to sell at the end of the harvest and know how much money they would have to plant their fields, on the other side of that transaction, there needed to be somebody who was willing to bear risk, almost like writing insurance.

So for 130 years, since futures started trading, we have had a concept, and I believe it to be the right one, sir, where commercial interests, farmers, ranchers, and then later oil producers and natural gas companies and grain elevators and so forth, all wanted to

have a reliable price for their product so that they can make business decisions.²¹ Well, on the other side, then there is somebody in essence writing—taking on that risk. It is not an insurance company. In fact, it is somebody we call a speculator, somebody who is taking a position on the other side.

What is at the heart of the CFTC authorities dating back to its founding is that that is to be allowed, but we also want to protect against excessive speculation and the burdens of excessive speculation, and there is a whole regime of position limits to limit that, and there is also clearly an important public interest to protect the American public against manipulation in markets. And sometimes when you see spikes like this, you say it broke down. What was happening may have broken down.

Chairman HARKIN. Could the CFTC have started to do something in here to stop that speculative bubble in oil prices?

Mr. GENSLER. I believe that all of these products need a consistent regime of position limits and those position limits should apply around the globe. The CFTC, in working with Congress, has addressed a number of these features. In the farm bill last year, I believe, to the credit of this committee, working with other members of the Senate and the House, you put in place a way to close part of that. There is also things that the CFTC has done subsequently, working with the regulators in London to try to address some limits so there is more transparency and that limits, where they are in place, apply to all markets consistently around the globe.

Chairman HARKIN. Well, at least with the oil market, you could see it happening. But I would like to turn, if I could, to over-the-counter derivatives, which really is an opaque market and which you can't see happening. First of all, would you agree or slightly agree or disagree with the statement that derivatives are more like futures contracts than just about anything else. Is a derivative a futures contract?

Mr. GENSLER. Senator, a future is actually technically a derivative. A derivative is just a broader term, and I believe that all of these products have great similarity. So I think that hopefully answers the question. And what they have similarities is that they derive their value from some other product. A future derives its value from the corn or wheat or—

Chairman HARKIN. That is a future. That is right.

Mr. GENSLER. That is a future, and an over-the-counter derivative derives its value possibly also from corn or wheat or oil or it might be from underlying interest rates. So they are very similar products. They are all forms of financial instruments that derive their value from some underlying feature.

Chairman HARKIN. OK. And a derivative's value basically depends on something happening in the future. A derivative is tied to something either happening or not happening in the future. So I always think of derivatives trading as a futures market. So, therefore, why should they be exempted? Why should they be exempted from the CFTC?

Mr. GENSLER. Mr. Chairman, I believe that the entire over-the-counter derivatives marketplace, we need to bring those standardized products onto centralized clearing, and we get a great benefit

from centralized clearing and we will lower the risk in the system and add to transparency. We actually attempted to do some of this 8 years ago and there was a voluntary clearing mechanism that was in that bill. I believe now it should be mandated for interest rate product, currency product, commodity product, credit default swaps, and the equity products, the whole regime.

I also think the standardized products, we get great benefit from the transparency that can come from being on exchanges. There are some exchanges for these derivative products, but we can get a great deal more benefit from transparency from bringing those standardized products onto exchanges.

Chairman HARKIN. Help me think through this. I have a concern that you keep using the word "standardized," and I saw that in your response to questions asked of you by both Senator Cantwell and Senator Levin. And you referred to it a number of times here, about the standardized credit default swaps for example, standardize.

But it seems to me that if someone wanted to trade in an over-the-counter derivative market and not on a regulated exchange, they could simply do little things to make the contract customized, and you can't, in all your wisdom, define every little thing that could make it a customized rather than just a standardized swap or derivative. So how can you have both a regulated exchange for standardized, and then an over-the-counter for customized? How do you define what is custom?

Mr. GENSLER. Mr. Chairman, I couldn't agree with you more. I believe that is why we also need, working with Congress, to come up with a regime for the customized product. There is still commercial interest, whether they be a grain elevator or it can be an airline that wants a certain grade of jet fuel delivered on a certain day to a certain airport, and those dates and that grade of jet fuel and that airport may be different than a particular contract. That is customized.

But at the same time, if we bring reporting to that and required reporting, required capital or margin requirements, and we level the playing field between that and what might be the standardized products, I believe that working together still allows the legitimate commercial interest to try to hedge in that little example a particular jet fuel at a particular date at a particular airport.

Chairman HARKIN. Maybe there is something here I don't understand, because I have thought about this a lot and I have read a lot about it. But it just seems to me that if you are going to close the loophole, you have got to put them all on a regulated change. If someone says they have got a custom deal, well, put it on the exchange anyway. Then we know what you are doing.

Many thousands of contracts would avoid daylight by one little custom change. I have said before, if you and I want to swap something, you want to swap your tie for my tie, no one else cares. But if you own a whole portfolio of stocks and bonds and you want to swap that for my little piece of land someplace that may have tenants on it and things like that, well, then you see a lot of other people are involved in that custom swap.

And I am thinking, why not just put those on a regulated exchange? And if you can't do that, well, then you are just—you just

outlaw those customized kind of swaps unless they are willing to put them on a regulated exchange.

Mr. GENSLER. Mr. Chairman, that is why actually I believe that we, in addition to what we are talking about, also bring a full regulatory regime to the dealers themselves, these large financial actors that deal in these markets. My fear, Mr. Chairman, of saying they are outlawed entirely is not only that which might hurt, whether it is a grain elevator in Iowa or whether it is an airline that wants a certain jet fuel on a certain date in a certain city, that they will find some other way. That is true economics. An airline wants to hedge that risk some other way that is then outside of the regime.

So I think working with Congress, if confirmed, I would look forward to making sure that 100 percent is reported, that it is not opaque, that it is all brought in and aggregated into central data warehouses, which I know a number of Members of Congress have looked at and worked on, that there is no hole in the bottom of the boat that it all flows out of, but that the hundreds of products and the great majority of the products that are standardized are on exchanges, and if an exchange accepts it on the exchange, it has got to be on the exchange. And if the clearinghouse accepts it in the clearinghouse, it has to be in the clearinghouse.

But we still—like you said, if we swap ties—and I do like your tie—but if we swap ties, Mr. Chairman, that it might well be that that has to be reported and we have to have capital charges for it but not have that on an exchange.

Chairman HARKIN. I see Senator Klobuchar is here and I am going to yield to her. I have more to go into on the topic in a little more depth, but it just seems that once you have an over-the-counter market, derivative market for customized contracts, you can just about exempt anything. If I have a futures market that says the expiration date is July 20, but then I say, no, I need July 21, does that make it a custom contract? Does that exempt it from exchange trading? That is what I mean. It just seems to me I can make any little change and all of a sudden I am exempt and can trade the contract over-the-counter.

Now, you say, well, you report the trading anyway and so forth, but I am still not certain that gets to the nub of the benefit of putting the trade on that regulated change where every day it is transparent. One can know exactly what is happening and you don't have these customized things drifting around out in the OTC market. I think you just open the door for proliferation of inadequately regulated OTC trading.

Mr. GENSLER. Mr. Chairman, you and I share exactly the same goal, that we bring this whole marketplace into what I believe is two regimes. One regime is the centralized clearing in the marketplaces. The other regime is that the dealers themselves have serious regulation on capital, business conduct, and reporting, and that we rely on both to bring a marketplace that is very important and large into our economy, but under regulation.

Chairman HARKIN. Thank you very much, Mr. Gensler.

Senator Klobuchar?

Senator KLOBUCHAR. Thank you very much, Mr. Chairman. We will have to leave the tie swap idea behind because I don't have one.

Mr. GENSLER. Thank you, Senator.

Senator KLOBUCHAR. But I wanted to congratulate you on your nomination. I appreciate, Mr. Chairman, that this nomination hearing was held in such a timely manner, given what we are facing here, how important it is, and that we need a cop on the beat to monitor commodity trading and giving us good advice about what to do with financial derivatives.

I just noticed that the President at this very moment is holding a press conference on financial regulations and what he thinks needs to be done here. I have been just stunned by everything that has gone on here. I remember your predecessor, Mr. Lukken, when he appeared before our committee, and as a former prosecutor, I was giving him some ideas of the things that I thought maybe we could give to him as tools to use to improve things.

We talked about staff improvements, which I think is important, or additional staff. But then we talked about this idea of more tools and he actually said, no, he didn't want that tool. No, he didn't want this tool. We talked about the London loophole or would he like more ability to go after certain things, and he said that he didn't want that ability.

I said, you know, as a prosecutor, you want—if you think a statute will help you with a certain group but you are not sure if you are going to use it, you still might want that statute. I just wonder how you would respond to that, because that is what most stunned me about that hearing.

Mr. GENSLER. Senator, thank you for asking the question and taking the time at this hearing in your busy schedule. I absolutely believe the CFTC needs more tools, unambiguously. I believe it has to be a tough cop on the beat and strong on enforcement. We need more resources to do that. I mentioned to some others that the enforcement wing itself has 150 lawyers, was shrunk to 110. This is in a period of time that the futures markets went up sixfold in volume, in the last 8 years.

But beyond that, I believe that we do, working with Congress, have a broad agenda, if I am confirmed, to try to get additional authorities to address some of the very real issues in the agriculture and energy markets and the over-the-counter markets to control some of the excesses that we have seen.

Senator KLOBUCHAR. Well, one of the things we talked about last year was closing the so-called London loophole, to stop traders from routing transactions through offshore markets to get around limits on speculation. I worked with Senator Dorgan and a lot of others on this speculation issue. Do you think that would be helpful?

Mr. GENSLER. Senator, I do. I congratulate your efforts on that. I think that the CFTC has done some things administratively, but I think it would be very helpful, working with Congress, if confirmed, to actually have that in statute. And it is really—the core principle I would have is that markets are so interlinked around the globe that if it affects American consumers, that we should make sure, even though we might have reciprocal arrangements with other regulators around the globe, that fraud and manipulation, that position limits and reporting have some consistent regime. And so I would look forward to working together on that and

I do believe it is important to have these position limits apply to various trading platforms around the globe.

Senator KLOBUCHAR. You know, credit default swaps have been blamed for helping to accelerate the over-leveraging on Wall Street. Do you share this view and do you think that something should be done about this?

Mr. GENSLER. Senator, I believe a great deal needs to be done with regard to the over-the-counter derivatives marketplace, not just credit default swaps but, as the Chairman and I were discussing as you came in, to bring the whole over-the-counter derivatives marketplace into a regulatory regime with centralized clearing and exchanges.

Senator KLOBUCHAR. Right.

Mr. GENSLER. But beyond that, I do think credit default swaps raise an additional set of unique challenges. In AIG, we saw a book of business that wasn't even regulated. The transactions weren't and the financial institution wasn't. I am recommending that those should be regulated, and the credit default swaps' unique properties, because often they are very much like a corporate bond and it is a corporate bond with a lot of leverage in it. And I believe that regulators need there to work together to find the appropriate controls in addition to clearing and exchanges. I think there is appropriate further regulation in that market that is needed.

Senator KLOBUCHAR. Good. One last question, following up with the last questions that the Chairman was asking with the custom issue. Last September, the CFTC issued a report on the over-the-counter markets and it contained some recommendations, and one important recommendation was to create enforceable position limits by developing limited risk management exemptions for swap dealers and requiring dealers to, first of all, report to the CFTC about large customer positions, and second, certify that none of the non-commercial customers exceeded specific position limits in related exchange trading contracts.

Do you support this action? Do you think that this is a recommendation, and should that rulemaking activity continue?

Mr. GENSLER. Senator, I do, but even further, as I understand it, and again, I look forward to learning more about this, if confirmed, but these various position limits that are at the heart of the framework to comply with the mission of this agency have some exemption that have been issued going back nearly 20 years. Many of them were issued by staff, "no action" letters. I believe that every one of those exemptions needs to be reviewed. As Chairman, I would be looking forward to working with my fellow Commissioners, Mike Dunn and Bart Chilton, Jill Sommers, Walt Lukken, and really take a look at all of these.

And second, also look at the process of issuing "no action" letters themselves. Some should stay at staff level. But others really are consequential and that is why you have Senate-confirmed people in the jobs to look at these things.

Senator KLOBUCHAR. OK. Thank you very much. I appreciate it.

Mr. GENSLER. Thank you, Senator.

Chairman HARKIN. Thank you, Senator Klobuchar.

Senator Chambliss.

Senator CHAMBLISS. Thank you. If I could go back to the Chairman's chart there for a minute, Mr. Gensler, and I want to see if I can ask this question the right way. I don't want to take your language and interpret it in some way other than exactly what you meant. But when you talk about the spikes in the market and you talk about speculators causing that huge spike, is it not a fair statement to say that speculators who sought to manipulate the market are the ones that may have influenced that spike versus speculators per se causing that spike?

Mr. GENSLER. I think that what I believe is that there are many contributing factors, that we have had in our economy and around the globe many imbalances, low savings rates here, very high savings rates, nearly 40 percent saving rate in China. There are great global imbalances that have been flooding into markets.

Within those global imbalances, I believe that commodities started to be viewed as an asset class for investment. And so one of the contributing factors—there were other contributing factors, too, but one of the contributive factors, I think, is as investors started to look at commodities as an asset class, and unfortunately, over the globe, risk was underappreciated, terribly underappreciated, and when I say that, I mean it was underpriced.

There were too many investors, and, yes, speculators who thought it was more likely that something would go up than down, that the demand factors from China and India or the low refining capacity would keep pushing these prices up. And that collective misjudgment of market participants is what I think you see there, but not necessarily—I don't have the facts or figures to say that it was manipulation, sir.

Senator CHAMBLISS. You made a statement which I think is correct and which I have argued with my colleagues who would like to see all speculators eliminated. Are you going to have a market that functions properly without speculators?

Mr. GENSLER. Senator, again, I think at the heart of the futures market since the first contracts, I believe, were put in place in the 1870's is that for a hedger to have somebody on the other side who is willing to bear that risk, we call the person on the other side a speculator. We need—the markets need that so that the commercial interests, the farmer, the rancher, the grain merchant, has somebody on the other side to bear that risk.

Senator CHAMBLISS. And you have been on both sides of this. You have been on the investment side as well as on the regulatory side. You have got extensive experience on both sides. If an investor in the market, somebody who trades in the market regularly, is overregulated, including adding position limits, and they have the availability of going offshore, what is that person as an investor who feels like he is overregulated going to do with respect to the American market that CFTC regulates versus trading offshore?

Mr. GENSLER. Senator, I believe these markets are completely interlinked at this stage. So I think that it is critical that the U.S. regulators work with our global counterparties in Europe and in Asia to assure ourselves that there is consistent regulation. And where we are unable to get that consistent regulation, to work still to protect the American public the best we can as to the transactions with the American public, or where there is American prod-

uct, a product like West Texas intermediate, or products that are right here.

But I agree with you, sir, that paramount is working with the global regulators. I believe that we can find that consensus. But if confirmed, I know there will be challenges to hopefully make sure it is around the globe.

Senator CHAMBLISS. Well, if you are an investor, whether you sit in Washington or New York or Atlanta, and you want to buy a contract of a product that is sold internationally or on a market that is regulated by CFTC and you have got the choice of where to go to buy that, as an investor, are you going to look for a market that gives you the greatest amount of flexibility and therefore the greatest opportunity and a safe way to ensure a profit, or are you going to go to a market that just overregulates you to death?

Mr. GENSLER. Senator, I think that investors in these markets are so interlinked that they will find a fungible place to go, and that is why, if confirmed, my commitment to you is to, first, to raise with you and the rest of the administration what rules I think will best protect the American public, but then second to work feverishly with international regulators to try to see if they agree, and where we agree, hopefully adopt a consistent regime. Where there are disagreements, at least come back to this Congress and the administration, because those differences will possibly be important. Hopefully, those differences won't be, but they may be really important to the American public.

Senator CHAMBLISS. Well, I think all of us want to make sure that the American public is totally protected and make sure that anybody who invests in the market is going to have the assurance that somebody is looking over their shoulder. But the fact is that these markets are traded on by individuals who are extremely sophisticated, and as you said, things have changed so much over the last 9 years. Gosh, we didn't have electronic trading back then, and now, very few trades probably are not in some way not connected to the electronic side of it.

And I know from talking to traders who have told me, look, you start putting position limits on me, pure and simple, hey, I can trade on the London Exchange from Atlanta just like I can trade on ICE or CME or New York Exchange, and that is what we will do. I just want to make sure that there is a clear understanding that we can go too far and we have got to be careful about that.

Mr. GENSLER. And I think that, Senator, you and this committee and the rest of this Congress worked last year, as I understand, in the farm bill to say contracts that look like the contracts here—they are called look-alike contracts—that had a particular relevance to these markets here, those were the ones that position limits.

There may be other contracts overseas that really are on other markets involving other products. But where it really was sort of almost like twins, those look-alike contracts, it was appropriate to have consistent regulation. But I certainly, if confirmed, understand it, as you say. I think that my experience both on Wall Street and in government provides a certain background to understand, exactly as you said, that we have to get this right.

Senator CHAMBLISS. With respect to the standardization of products versus the customized products out there, I think if I heard you correct, you say that there ought to be a clearinghouse for the standardized products. But you and I, I think, agree that we have got to be very careful with the customized products because I am not sure how you do that, how you are going to have a clearinghouse for all customized products.

I know one thing that has concerned some of my colleagues is that the way we all know these markets work are that a customized product may change hands two or three, four, five, ten times in one single day, and how in the world we are going to clear all of those in a manner that has a regulator looking over their shoulder, I don't know. I am concerned about those types of contracts certainly going overseas.

But am I wrong in my thinking somehow? Is there some way that you think that we can come up with a regulatory process that not only is a clearinghouse for the standardized product, but the customized product, also?

Mr. GENSLER. I do, Senator. I know these are very complex markets and these are challenges, but I do, and I think that there can be a product that changes hands multiple times a day is probably, with all respect, more standardized than customized. There has been a number of approaches, I know both here in the Senate and the House and some draft bills on how to define what might be customized.

But centralized clearing adds a great benefit because it means that these individual financial institutions, these 15 or 20 large financial institutions, are no longer exposed to each other. And one of the great calamities of this past crisis is that one financial institution couldn't fail because if it failed, it was like interconnected, so interwoven that it was going to bring down the whole system.

One of the big benefits of centralized clearing is that all of these trades, rather than with each other, is with a central mechanism, and there would be a posting, like on the futures exchanges, a posting of collateral on a regular basis. AIG, when it got the call, had to post \$40 billion of collateral. Well, we know what happened then. The U.S. taxpayers stepped in and loaned the money to AIG.

I believe we really have to work feverishly and urgently to try to make sure that doesn't happen again. I think that centralized clearing, I think the bias that I am suggesting is toward getting those contracts in, and if a clearing mechanism, and there are a number of competing clearing mechanisms, but if a clearing mechanism would accept a contract, that is certainly one test it should be there, and then Congress can also dictate certain rules. I mean, there is a lot that we would need to work together, if confirmed, on how to structure this. But I do think it does help lower the risk tremendously.

Senator CHAMBLISS. The "no action" letter, would you support elimination of "no action" letters, or do you support still utilizing the "no action" letter process in appropriate situations?

Mr. GENSLER. As I have come to understand it, all of the major regulatory agencies, whether it is the FTC or the SEC, CFTC, has a form of "no action" letters. There are some things that are truly

administrative and staff writes a letter and says they are not taking an action.

What I believe we need to do at the CFTC, working with the other Commissioners, is really look at that process and see how is that done and which ones are consequential and which should come up to the full Commission, a five-member Senate-confirmed Commission. So I believe at the end, there would still be some that are really truly either administrative or ministerial or consistent with role, but there are consequential ones, I believe looking now in hindsight, and hindsight is—I know we are foresight here, but I believe that we need probably to really look at which ones come up to the full Commission for their consideration.

Senator CHAMBLISS. Last, let me just say, I think Senator Lugar had a really good point. Even in Math 101 at the University of Georgia, they taught me that if you can buy something for \$1.96 in the United States and take it to Europe and sell it for \$20, that is a pretty good deal.

I can envision 10 years down the road, if we have a true cap on trade system, we are going to see these things traded on a global market. So I just say that is something that has got to be in your line of thinking here as we go through the next 12 months, 24 months, whatever it may be, if something does come out of Congress in that respect, because, gee whiz, you talk about electronic trading being a milestone. This is going to overwhelm us, it would look like to me, with this international cap in trade system that we potentially have out there.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Chambliss.

We have been joined by our distinguished colleague from North Dakota, Senator Conrad.

Senator CONRAD. Thank you so much, Mr. Chairman and Ranking Member Chambliss. Thank you, Mr. Gensler, for being here.

I was here earlier and had to go to—you know how this place is—other obligations. I very much apologize for not being here for the rest of the hearing. I was so struck by having Senator Mikulski, Senator Cardin, and one of my all time favorites, Senator Sarbanes, here, and it reminded me of my favorite story about Senator Sarbanes, who was a great baseball player in his youth.

Mr. GENSLER. He was. He was. Not a lot of people know that, but it is true.

Senator CONRAD. Yes, he was a terrific athlete. He was selected for the Maryland All-Star Team as a shortstop, and he went to the practices and it came time for the game and he was listed as starting at second base. And he went to the coach and he said, "Why is it that I am at second base? I was chosen as the shortstop." And the coach said, "Kaline will be playing shortstop."

[Laughter.]

Senator CONRAD. That was Al Kaline. And I thought, that is a great story, isn't it?

Mr. GENSLER. It is terrific.

Senator CONRAD. Sarbanes had to stand aside for Al Kaline.

Well, you, in essence, are coming into the big leagues, too, and this is a different kind of big leagues. Our country and our world are in very serious shape. I just spoke to a group from back home

talking about how we got in the situation we are in, and I believe it is a combination of a very loose monetary policy, a very loose fiscal policy, a very loose trade policy, all coupled with deregulation, that created the seed bed for bubbles to form. And we didn't get just a housing bubble. We got an energy bubble. We got a commodity bubble. And when those bubbles burst, it did enormous damage. There is a lot of wreckage here. And all of us have responsibilities.

While I fought against what I thought was a very dangerous fiscal policy and a dangerous trade policy, I, along with others of my colleagues, voted for the Modernization Act, which you supported, and I look back, while there were many good things in the Modernization Act, I think there was one part of it that was very, very wrong, and I regret deeply my own going along with it, although I had grave reservations about it, and that is the question of credit default swaps and derivatives and whether or not they are regulated. You and others told us, don't worry, these are very sophisticated players and there will be a self-regulation because they are better able to monitor those markets than we are.

Well, the more I have looked into it, the more convinced I have become that this is one of the great Ponzi schemes of all time. We think about Madoff's Ponzi scheme. That is a \$50 billion Ponzi scheme. I think derivatives, while probably the vast majority of it is completely legitimate, the part that was not was the assessment of risk, the assessment of risk.

Last year, I was with a man who was head of all derivatives trading for one of the major global financial firms and I said to him, have you ever looked at the formulas these PhDs in math have come up with to determine risk in these contracts? He said, "Yes." I said, could you understand it? He said, "No." I said, I will tell you—and this is the guy who was in charge of all derivatives trading. I said, I have got a master's in business. I asked my staff to bring me one of these formulas. I couldn't make head nor tails out of it. And it turns out they didn't have in these risk formulas any assessment of housing prices going down.

Well, to make a long story short, all of us who participated in supporting that bear responsibility. There are many other elements, the fiscal policy, monetary policy, other deregulation that was done. But you, too, have responsibility, because, you know, at least for some small part of that, you gave us bum advice.

What can you say that would make us comfortable, if we have that view, and maybe you have got a different view and I certainly respect that, especially in the presence of your daughters, who are very patient—what would you say to us who are now deeply concerned about the mistakes that were made? What would you say to assure us that you would be part of the solution?

Mr. GENSLER. Senator Conrad, I appreciate the question. Looking back now, it is clear to me that those of us involved at the time should have done more to protect the American public through strong, comprehensive, and aggressive regulation. There are some things that we raised and looking back now should have fought harder for, to regulate the actual institutions, the derivative dealers, to keep oil and metals consistently regulated with wheat and corn and other products. We should have fought—we did rec-

commend that, but in the final bill were unable to achieve either of those. We should have fought harder.

I think there were also things that were but dots on the landscape. You raised credit default swaps at the time of that legislation. Approximately 97 percent of the market were interest rate derivatives and currency derivatives, and the bulk of the remaining 3 percent was actually equity derivatives and commodity derivatives, as small as they were back then. And that market has burgeoned since then.

Senator CONRAD. Exploded.

Mr. GENSLER. And in very consequential ways, where an AIG had a hook of business so significant, and I believe that those credit default swaps at AIG were often being misused, and sometimes by regulated institutions, banks in Europe that were getting protection and lowering their capital charges with regard to that.

I think also, Senator, and you raised this in your question, I think there was an assumption at the time about whether the regulation of institutions, these large financial institutions, would be enough. And I do think in retrospect that assumption was thoroughly tested for a couple of reasons.

One, even where there was broad regulation, at the holding company and of everything, there was no specific regulation of the derivatives affiliate. I believe that even now, where the Federal Reserve might have broad holding company regulation, that if confirmed, I would look forward to working with Congress and the other regulators to make sure that the dealers themselves have to have capital, business conduct, and reporting requirements. But capital is the shock absorber, so to speak, to guard against excess leverage. I have come firmly to believe that.

At the same time, I believe that we need to have a full regulatory regime for the market so that the centralized clearing, and we could get the benefits of centralized clearing as we have in the futures market, and those benefits might sound like back-office plumbing, but they are very real because just as in the futures markets, you have to post margin on a regular basis and have a sort of a daily reckoning of these contracts and at the same time have to send in the information and have all the positions and the recordkeeping and reporting.

Exchanges bring transparency to transactions. Where small businesses, small commercial interests right now, I believe, actually pay more for even the standardized products, more because they don't have that transparency. Now, just one basis point might be a little bit, but transparency to an overall market, I think, brings further economic prosperity, as well.

So I do think, looking back now, it is clear to me we should have done more. But over time, I believe that some of these weaknesses have been sorely tested. The regulatory and financial system completely failed the American public in this regard. And I look forward, if confirmed, working with you, as I did with Senator Sarbanes, to try to sort of sort through some of that complexity, the dust that might be kicked up by opponents, and they will be very strong and loud opponents, some of them raising legitimate concerns, but trying to find how we can best protect the American pub-

lic and bring a regulatory regime to a field that hasn't had one to this date.

Senator CONRAD. Well, I appreciate that answer. You know, I look back. I have been trying to write an analysis of what has happened here, a broader look at all the factors that contributed, and I do very much believe that it is a very unusual combination of a loose monetary policy, after 9/11 we had very low interest rates for a very extended period of time, a very loose fiscal policy with massive Federal deficits.

At the time when the economy was strong, we still had a very loose fiscal policy, very unusual to have loose monetary policy and loose fiscal policy simultaneously, coupled with very loose trade policy with record trade deficits. And then the deregulation that occurred and, you know, I will stand up and I will be held accountable. I made a mistake.

I mean, I will assert there were many good things in that Financial Modernization Act, but I believe there was an Achilles heel that some of us were worried about at the time but we thought the good things would overcome that weakness. Well, we were wrong and we were wrong big time and all of us need to fess up about mistakes that have been made here. We have got to try to get this back on track.

I thank the Chairman for your patience.

Mr. GENSLER. Senator, I thank you for that. I agree with your assessment, if I could, Mr. Chairman, that there was a great many things that were imbalances, and you named those, but also the regulation, that if confirmed, I would look forward to working with you and this Congress that we really do bring a full regulatory regime not only to the institutions, which I think we need to do, but also, as the Chairman has laid out in his bill, with the goal to bring it to the markets, as well.

Senator CONRAD. Thank you, Mr. Gensler. Thank you for your very honest answers.

Mr. GENSLER. Thank you.

Chairman HARKIN. Thank you, Senator Conrad.

Well, Mr. Gensler, this has been a great hearing. I think we have gotten great responses and an open and frank discussion. I don't mean to belabor it any longer, although in listening to just the last two questioners here, Senator Chambliss and Senator Conrad, I was just jotting down here CMS, CVOs, CMOs, CMBSs that is commercial mortgage-backed securities—CDSs. Now we have gotten into things like CDO-squared, CDO-cubed, and you just keep slicing these tranches of derivatives out there all the time.

The financial sector has come up with all of these exotic products. No one really understands them except maybe a few people on Wall Street, and they may not fully. But credit default swaps didn't exist before about 1998, not really.

Mr. GENSLER. That is right, sir.

Chairman HARKIN. And the world seemed to operate just fine without them. The same with collateralized debt obligations or collateralized mortgage obligations. All this creativity in new contracts happened in the early 1980's, through the late 1980's, and then they really boomed in the 1990's, all these different derivative contracts and financial products.

I asked the question in our October hearing, I said, what market forces out there demanded these products? Who was demanding this? The answer came, no one. It is just that a few of the financial institutions had some of these whiz kids and mathematical geniuses. Now they have big computers that could slice and dice these obligations into all these little tranches, securitize them as bonds, and then sell tranches, a highly leveraged tranche, or one that is not so highly leveraged, and on and on until finally you get this morass out there of instruments that no one really understands.

I asked Secretary Paulson one time when we had one of our meetings last fall, before the TARP. I said, why don't we insist, if we are going to put this money out, we insist that each one of those entities receiving this federal money give us a valuation of each one of those instruments that they have and insist on what is the value. His response, and we were all in that room together, his response was, "Well, they don't even know what the value is." Billions of dollars, and they have no idea what the value is.

Well, I don't know. I just think we have to—and this is not really in your bailiwick, but I just think we in the Congress have to really think about whether or not all these financial products and instruments are worthy of legitimacy. And they are all off exchanges. These aren't on exchanges. We have no idea what is going on out there. So I don't know if they are legitimate or not. I tend to think in some of these cases they are probably not, especially when you get into synthetic derivatives or you get into the naked credit default swaps. It boggles the mind about what people are doing with these instruments.

Now, it would be all right if these investment bankers were using their own money to do that. I could care less. But they are using my money, your money, my constituents' money that is in 401(k)s, pension plans, all other kinds of devices where they have taken money now and are investing it in these and so they are playing with our money.

So I just raise the question, I guess, on markets. We all believe in the market, but as you pointed out, I think for a market to really function, you have to have three things. Correct me if I am wrong. You have an MBA; I don't.

[Laughter.]

Mr. GENSLER. But an MBA, sir, doesn't mean—with all respect, it doesn't mean that you have—

Chairman HARKIN. I am just kidding you. My daughter has one. I keep asking her this. But it seems for a market to function, you have to have many buyers, many sellers, and transparency. If you mess up one of those, you don't really have a market. You may call it a market. Many buyers, many sellers, transparency. Once you have few buyers, many sellers, or you have buyers and sellers and you don't have transparency, you don't have a market.

And so when we talk about markets, we have to keep in mind just what we are talking about. What kind of markets do we want? Very few real markets exist any longer out there.

Mr. GENSLER. Mr. Chairman, I would—I know that you mean this, but I would add something else to what is a component of markets. We need regulation. We need regulated markets and so

that is what I am here to say, and if confirmed, I would look forward to working with you. Senator Conrad had asked me about what I had done in the past, and, I mean, I even wrote a book called *The Great Mutual Fund Trap*, and it wasn't by mistake that on the cover of the book it has that old three monte game. I mean, I just brought it here just because I remember it. But there is a reason that the book has that here.

Chairman HARKIN. I have got to read that.

Mr. GENSLER. Well, we will give it—it is all right if you don't read it. I am just saying there is a reason that is there.

Chairman HARKIN. But what I say about sellers, buyers, and transparency, that is what is called the, quote, "unfettered free market." Now, you are right. Do we want an unfettered free market? Do we want the free flow of capital? I hear that all the time. I read that we want the free flow of capital. Well, an economist who was at our hearing in October said, I am not certain we want the free flow of capital. We want the efficient flow of capital.

And he used an analogy which struck home with me. He said, well, it is like traffic. If you want the free flow of traffic, get rid of all your stop signs. Get rid of the stoplights. Get rid of the speed limit signs. Get rid of all the warning signs. You will have the free flow of traffic, but you will have a lot of wrecks. What you want is the efficient flow of traffic.

The same is true in financial markets. You want the efficient flow. Therefore, you need the stop signs and the caution signs and the regulations so that capital is efficient, not just free.

So anyway, I just wanted to make that point, to say that I think we really have to take a look at whether all of these types of instruments are really necessary and legitimate. If they are, they ought to be regulated. That is all I am saying.

Now, this does get into your bailiwick. Every single one of those instruments, I submit, is a future. Every single one of them is some derivative and it is based on something happening or not happening in the future and therefore would come under the purview of the CFTC. I don't know if you have any comment about that, but if we are going to continue these kinds of contracts, should they not be regulated?

Mr. GENSLER. Sir, I believe that we do need regulation and many of the list, and it was a bit of an alphabet soup for the public, but many of them are actually currently even regulated around what is called asset securitizations, not by the CFTC, but by the SEC as securities. Collateralized debt obligation is actually an asset security.

And I believe that part of regulatory reform, as the President has called for and Congress and the President are going to work closely together, and if confirmed, I am eager to lend a hand there, is that I believe that we really have to look at all asset securitizations, whether they are called collateralized debt obligations, asset-backed securities, commercial mortgage-backed securities that you mentioned, or even asset-backed securities, uncollateralized debt obligations, which because there are two sets of letters there, somebody caused that squared term you called it. That whole world of asset securitization needs to be looked at.

At the same time, the American public, though, needs the benefit of capital to start moving again, to purchase their automobile, to have the student loans, to get their credit cards rolled over, and to get their mortgages, and a lot of that is done in this securitization market, particularly as banks have so constrained their market.

So we need the rules, just like you said on the road. We need that flow of capital to the American homeowner to get the student loan, to get the car loan, to get their mortgage. But at the same time, I believe, and if confirmed, I look forward to working with you on the additional regulations that are needed even in the world of asset securitizations that come under another regulator than the CFTC.

Chairman HARKIN. We need to discuss this further because I had a student loan, and I bought a car with a loan long before any of these derivatives ever existed. So what was wrong? I don't know if these derivatives are necessary for people to get car loans or student loans or mortgages or anything else.

Mr. GENSLER. It worked well in America and it worked well for you. As many things were just dots on the landscape eight or 9 years ago, this market, too, has taken off, and so I believe it is time to work together as regulators and with Congress to see what additional rules are necessary there. Again, somewhat out of the jurisdiction of the CFTC.

Chairman HARKIN. That is true, and some of what I described is not part of the CFTC's jurisdiction.

Senator CHAMBLISS. Mr. Chairman?

Chairman HARKIN. Yes?

Senator CHAMBLISS. One reason that I was kind of pursuing a line of questioning relative to what may happen with respect to off-shore trading is I think Mr. Gensler is exactly right, that we didn't envision 10 years ago what was going to happen in the marketplace. You talk about eliminating products. Shoot, there are some smart guys out there right now that are thinking about additional products.

Chairman HARKIN. That is true.

Senator CHAMBLISS. We can't even conceive what they are.

Chairman HARKIN. That is true.

Senator CHAMBLISS. But the one thing I am impressed with is that when you say that we need to think this through and we need to make sure that we regulate these in the right way, we have got to look ahead to what type of products there may be out there that get us into this same mess again 10 years, 20 years from now if we aren't careful. We are never going to be able to anticipate exactly what those products are and nobody ever thought about packing mortgages and selling them five or six times a day.

If you talk about eliminating, I think you really cause problems. But if you are talking about making sure that you regulate in the right way and you give these guys the tools and the resources, primarily, which they don't have now, then I think we will do a better service to the consumer out there.

Chairman HARKIN. Well, Mr. Gensler, thank you very much. I thought this was a very enlightening session. I appreciate your forthrightness.

We have several letters of support, and, I might add, one letter in opposition to Mr. Gensler's nomination. I ask unanimous consent that these letters be made a part of the record.

[The following information can be found on page 70 in the appendix.]

Chairman HARKIN. I ask unanimous consent that if there are materials that other Senators wish to submit for the record, that those also be included.

I will leave the record open until noon tomorrow for any additional written questions that any Senators want to submit to Mr. Gensler, and then the record will be closed at noon tomorrow.

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, if I can thank you both for your hearing and the inquiry. I also want to thank Senator Mikulski, Senator Cardin, and Senator Sarbanes on the record for their support. If confirmed, I look forward to working with you and your staffs on this very significant agenda we have forward.

Chairman HARKIN. Mr. Gensler, may I say that it is great you have had two of your daughters here. They probably think it is probably the most boring thing that has happened to them in a long time and they deserve to have a nice dinner out tonight.

[Laughter.]

Mr. GENSLER. I thank you. I think you are right about that.

Chairman HARKIN. Thank you very much. The committee will stand adjourned.

[Whereupon, at 4:56 p.m., the committee was adjourned.]

A P P E N D I X

FEBRUARY 25, 2009

Statement of Senator Thad Cochran

February 25, 2009

Mr. Chairman, thank you for holding this nomination hearing. This hearing is very timely considering the current economic situation and the ongoing review of certain financial instruments.

The role of the Commodity Futures Trading Commission (CFTC) to help protect market participants from fraud and manipulation has never been more important. As is the case with any economic downturn, consumers often times blame government agencies for their lack of oversight and enforcement. I commend the Commission's employees for their tireless work enforcing current rules and regulations. It is critical that this Committee review and move forward with this nominee and allow the CFTC to operate with a full slate of Commissioners.

As we move forward with a full review of futures markets, it is important to keep agriculture producers in mind. Unlike speculators, agriculture producers and their lending institutions depend on these markets to hedge risks. The price volatility experienced last summer brought about challenges for many agricultural market participants, and many questions about the real impact of speculators remain open.

I am pleased that the Commodity Futures Trading Commission has announced new initiatives to address the concerns which have been raised by agriculture industries.

This past year, the CFTC announced an investigation of the cotton futures market. I urge the nominee before us today to allow this investigation to move forward and at the appropriate time provide updated information to Committee Members. Price volatility in the cotton market resulted in significant losses due to increased margin calls.

In addition, I would like to briefly highlight increased funding provided through the fiscal year 2009 omnibus appropriations bill. As you may know, the bill provides an increase of over \$34 million to hire additional staff. This significant increase of funding will allow the commission to increase staff positions and improve surveillance and enforcement of the laws.

We should be careful to select well qualified Commissioners and give them the resources they need to carry out their responsibilities. I congratulate Mr. Gensler on his nomination and look forward to continuing our review of his qualifications.

Statement of Gary Genler
Nominee for Chairman of the Commodity Futures Trading Commission
Before the United States Senate
Committee on Agriculture, Nutrition and Forestry
February 25, 2008

Chairman Harkin, Ranking Member Chambliss, and members of this Committee, thank you for the opportunity to appear before you today. I am honored to be President Obama's nominee for Chairman of the Commodity Futures Trading Commission at this critical time for the commodities markets, and for our nation.

As a champion of the public's interest -- for farmers, consumers, small businesses -- the CFTC plays an essential role in our financial regulatory system and affects the lives of all Americans. I firmly believe that strong, intelligent regulation with aggressive enforcement benefits our economy and the public.

The current economic crisis clearly has shown that our financial and regulatory systems have failed the American people terribly. Those of us who have spent our professional lives around markets have to approach the current crisis with humility following these broad failures. We have learned the limits of our ability to foresee how markets may evolve, the importance for absolute candor with the public about the risks we face and the need for unceasing vigilance to address them. We have learned that there is no substitute for strong independent regulation and that transparency and accountability are essential throughout the system. We must always err on the side of protecting the American people.

Those are the lessons that I draw from what has dramatically transpired over the past decade. If confirmed by the Senate, I pledge to this committee that I will not forget these lessons.

We must now repair our regulatory system by enacting much-needed reforms that promote transparency, fairness, and safety. To be effective, these regulations must be able to adapt quickly to developing technologies, new products, and to changes in our global economy.

If confirmed, I will tackle what I believe are four essential priorities for reforming the commodities markets and the financial system:

- Strengthen Enforcement

First, the CFTC must vigorously fulfill its mandates: enforcing existing laws strongly, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation. I will work tirelessly to ensure the Commission leaves no stone unturned in ferreting out and putting a stop to activities and practices that hurt the American public. We also must work together to provide adequate funds for this agency which I believe currently lacks sufficient resources to fulfill its mission.

- Prevent Excessive Speculation

Second, I believe increased speculation in energy and agricultural products has hurt farmers and consumers. A transparent and consistent playing field for all physical commodity futures should be the foundation of our regulations. Position limits must be applied consistently to all markets and trading platforms and exemptions to them must be limited and well-defined.

- Regulate Over-the-Counter Derivatives

Third, we must urgently develop a broad regulatory regime for over-the-counter derivatives markets. Standardized derivatives should be brought into mandated centralized clearing and onto exchanges. Derivatives dealers need direct regulation, including capital, business conduct, and reporting rules. Additionally, regulations need to be developed for customized bilateral swaps while allowing commercial interests the benefit of these hedging tools. Credit default swaps, given their unique nature, also will require further regulation.

- System Wide Reform

Fourth, I believe that the CFTC must work with Congress, with other regulators, and with our global financial partners to ensure that the failures of our regulatory and financial systems, failures which have already taken a toll on every American, never happen again. Today's complex financial markets are global and irreversibly interlinked. We must ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards that we demand of our markets. This is the only way we can be sure that Americans are fully protected.

I am a proud believer in financial reform, tough regulation and enforcement. I have been privileged to have had broad exposure to financial markets, here and in Asia, in public service and on Wall Street, as an investor advocate and a government official.

My experiences have taught me the importance of having a strong working relationship with Congress. In these transformational times, we have a unique opportunity – working together --to bring bold and necessary reform to our financial market regulation. We must make the most of the opportunity to ensure that we deliver on the clear expectations Americans have set for us.

I would like to close by saying how much the support of my family and my three daughters – who will sacrifice much if I am honored with this challenge – means to me. Anna, my eldest, is a freshman in college and could not be here. Her sisters, Lee and Isabel, are with me and it gives me great pride to introduce them to you.

Thank you Mr. Chairman, Ranking Member Chambliss, and members of this Committee. I look forward to answering your questions.

DOCUMENTS SUBMITTED FOR THE RECORD

FEBRUARY 25, 2009

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used). - Gary Gensler
2. Date and place of birth. - (b)(6)
3. Marital Status (include maiden name of wife or husband's name). List spouse's occupation, employer's name and business address(es).

I am widowed, having been married to Francesca Danieli, who was an artist.

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

I graduated summa cum laude from the University of Pennsylvania's Wharton School in 1978, with a Bachelor of Science in Economics, having matriculated in September 1975. I received a Master of Business Administration from the Wharton School's graduate division in 1979, having matriculated in September 1977.

5. Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

I have had the following employment:

- a) Ernst & Whinney, staff accountant for the summer of 1978
- b) Goldman Sachs Group, 18 years from 1979 to 1997, a partner from 1988 to 1997. I joined the Mergers & Acquisitions Department in 1979 and assumed responsibility for the firm's efforts in advising media companies in 1984. I subsequently joined the Fixed Income Division in the Mortgage Department and then directed Goldman's Fixed Income and Currency trading efforts in Tokyo. My last role was Co-head of Finance, responsible for worldwide Controllers and Treasury for Goldman Sachs.
- c) See question 7 for government service

I have had the following associations with for-profit enterprises:

- a) Enterprise Community Investments, Director, 2001 to 2008
- b) New Mountain Capital, Advisory Board member and investor, 2001 to present
- c) Strayer Education, Director, 2001 to present
- d) WageWorks, Director, 2006 to present

I have had the following associations with non-profit enterprises:

- a) The Baltimore Museum of Art, Trustee, 2001 to 2007
- b) The Bryn Mawr School, Trustee, 2002 to 2008
- c) East Baltimore Development, Inc., Director, 2003 to 2007
- d) Enterprise Community Partners, Trustee, 2001 to present
- e) Johns Hopkins Center for Talented Youth, Advisory Board Member, 2003 to present
- f) Maryland Democratic Party, Treasurer, 2003 & 2004
- g) The Park School of Baltimore, Trustee, 2007 to present
- h) Robert F Kennedy Center for Justice and Human Rights, Trustee, 2008 to present
- i) Tilles Foundation, Trustee, 1989 to present
- j) University of Maryland, Baltimore County, Advisory Board Member, 2002 to 2007
- k) Washington Hospital Center, Director, 2006 to present

Though not ever as an employee, I also have had associations with various family entities as I have indicated to the Office of Government Ethics and the Commodities Futures Trading Commission designated agency ethics officials.

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

None

7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

- a) US Department of Treasury, Assistant Secretary for Financial Markets. September 19, 1997 - Confirmed by the Senate by Voice Vote. Grade: PAS
- b) US Department of Treasury, Under Secretary for Domestic Finance. April 21, 1999 - Confirmed by the Senate by Voice Vote. Grade: PAS
- c) Senator Paul Sarbanes, Senior Advisor in 2002, on the legislative effort that became the Sarbanes-Oxley Act

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None

9. Political Affiliation: The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Democratic Party

10. Other Memberships: List all organizations to which you belong, excluding religious organizations.
- a) American Automobile Association
 - b) The Baltimore Museum of Art
 - c) Maryland Athletic Club
11. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or commodity futures policy or related matters.
- Books – *The Great Mutual Fund Trap* published by Random House, September 24, 2002;
 Articles – None; Columns – I wrote two columns which appeared in the Baltimore Sun, one in May, 2001 about the challenges facing the US Postal Services and the other on February 11, 2002 about the State of Maryland’s Retirement Pension system. I do not have copies of either column. Speeches – None on the enumerated issues.
12. Health: What is the present state of your health?

Excellent

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

I will upon confirmation

2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

As a participant in a Goldman Sachs defined benefit pension plan, which was frozen in 1986, I am to receive a single life annuity of \$6700 per year upon reaching age 65 in 2022.

I have a total of 11041 vested stock options in a private company, WageWorks. (208 options with a strike price at \$3.33 and 10833 options with a strike price at \$4.14) In addition, I have 26959 unvested options that will terminate upon my resignation from the board of WageWorks.

3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)

No

4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in Federal commodity price support programs? (If yes, provide all details including amounts of direct government payments and loans received or forfeited by crop and farm, etc. during the past five years.)

No

5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a direct or guaranteed loan from or cosigned a note to the Rural Business-Cooperative Service, Rural Housing Service, the Rural Utilities Service or their predecessor agencies, the Farmers Home Administration, the Rural Development Administration, the Rural Housing and Cooperative Development Service or the Rural Electrification Administration? (If yes, give details of any such loan activity during the past 5 years.)

No

6. Have you, or any partnership or closely held corporation in which you have an interest, ever received payments for crop losses from the Federal Crop Insurance program? (If yes, give details.)
- No
7. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)
- None
8. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)
- None
9. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)
- None
10. Identify all investments, obligations, liabilities, or other relationships which involve potential conflicts of interest in the position to which you have been nominated.
- In connection with the nomination process, I have consulted with the Office of Government Ethics and the Commodities Futures Trading Commission's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Commission's designated agency ethics official.
11. Have you ever received a government guaranteed student loan? If so, has it been repaid?
- None
12. If confirmed, explain how you will resolve any potential conflict of interest, including any that may be disclosed by your responses to the above items.
- In connection with the nomination process, I have consulted with the Office of Government Ethics and the Commodities Futures Trading Commission's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Commission's designated agency ethics official.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

January 22, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Gury Gensler, who has been nominated by President Obama for the position of Chairman, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the Commodity Futures Trading Commission concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is a letter dated January 21, 2009, from Mr. Gensler to the agency's ethics official, outlining the steps Mr. Gensler will take to avoid conflicts of interest. Unless a specific date has been agreed to, the nominee must fully comply within three months of his confirmation date with any action he agreed to take in his ethics agreement.

Based thereon, we believe that Mr. Gensler is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures

January 21, 2009

Mr. John P. Dolan
Counsel and
Alternate Designated Ethics Official
Office of the General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

This letter describes the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Chairman for the Commodity Futures Trading Commission ("CFTC").

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1) or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that the interests of the following persons are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

I was formerly employed by Goldman Sachs as a Partner and terminated my position in 1997. I am a participant in a Goldman Sachs defined benefit pension plan, which was frozen in 1986 and will receive a single life annuity of \$6700 per year upon reaching age 65 in 2022. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of Goldman Sachs to provide this contractual benefit, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Within 90 days of my confirmation, I will divest my interests in the following entities, which I hold through Annabel Lee, LLC: New Mountain Affiliated Investors, New Mountain Affiliated Investors II, New Mountain Affiliated Investors (Cayman), and New Mountain Affiliated Investors III. With regard to each of these entities, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of the entity until I have divested it, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Upon my confirmation, I will resign from my positions with the following entities: the Park School of Baltimore; the John Hopkins Center for Talented Youth; the Robert F. Kennedy Center for Justice and Human Rights; Enterprise Community Partners; Washington Hospital Center; and New Mountain Capital. For a period of one year after my resignation from each of these entities, I will not participate personally and substantially in any particular matter involving specific parties, in which that entity is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

Upon my confirmation, I will resign from my position on the board of WageWorks. Upon my resignation, I will forfeit my unvested stock options in WageWorks. Because I will continue to own both stock and vested stock options in WageWorks, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of WageWorks, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Upon my confirmation, I will resign from my positions on the board of Strayer Education. Upon my resignation and consistent with the policy of Strayer Education, Strayer Education will accelerate the vesting of my restricted stock. I will continue to hold my stock in Strayer Education. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of Strayer Education, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

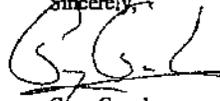
On June 30, 2008, I terminated my positions with the following entities: the Bryn Mawr School and Enterprise Community Investments. For a period of one year after my resignation from each of these entities, I will not participate personally and substantially in any particular matter involving specific parties in which that entity is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

Upon my confirmation, I will resign from my position with the Gensler Family Trust. Because I will retain a financial interest in this trust, I will comply with the requirements of 18 U.S.C. § 208(a) as to its holdings.

I have disclosed in my financial disclosure report a financial interest in the New Mountain Vantage Fund, which I hold through Annabel Lee, LLC. However, the fund's manager declined to provide me with sufficient information to enable me to disclose the fund's underlying assets in my financial disclosure report. Therefore, I will divest my financial interest in the New Mountain Vantage Fund within 90 days of my confirmation. Until I have divested New

Mountain Vantage Fund, I will not participate personally and substantially in any particular matter in which to my knowledge I have a financial interest, if the particular matter has a direct and predictable effect on the financial interests of New Mountain Vantage Fund, or its underlying assets, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Sincerely,



Gary Gensler

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | |
|--|---|--|---|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate box) <input type="checkbox"/> Incumbent <input checked="" type="checkbox"/> New Entrant, Nominee or Candidate <input type="checkbox"/> Termination Filer | Calendar Year Covered by Report <input checked="" type="checkbox"/> X <input type="checkbox"/> Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting Individual's Name Last Name: _____ Gender: _____ Title of Position: _____ Chairman: _____ | (First) Name and Middle Initial: _____ Gary Department or Agency (If Applicable): _____ Commodity Futures Trading Commission | Address (Number, Street, City, State, and ZIP Code): _____ Telephone No. (include area code): _____ | Reporting Periods Incumbents: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) (b)(6) | Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) None | Presidential Nominations Subject to Senate Confirmation Name of Congressional Committee Considering Nomination: _____ Committee on Agriculture, Nutrition and Forestry Do You Intend to Create a Qualified Domestic Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Certification I CERTIFY that the statements I have made on this form and all attached schedules are true, accurate and correct to the best of my knowledge. | Signature of Reporting Individual: | Date (Month, Day, Year): January 21, 2009 | Nominations, New Entrants and Candidates for President and Vice President: Schedule A—The reporting period for nominees (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. Schedule B—Not applicable. |
| Other Review (If desired by agency) | Signature of Other Reviewer: | Date (Month, Day, Year): 01-21-2009 | Schedule C, Part I (Liabilities)— The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. |
| Agency Ethics Official's Opinions On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below). | Signature of Designated Agency Ethics Official/Reviewing Official: | Date (Month, Day, Year): 1.21.09 | Schedule C, Part II (Agreements or Arrangements)— Show any agreements or arrangements as of the date of filing. |
| Office of Government Ethics Use Only | Signature: | Date (Month, Day, Year): 1/22/09 | Schedule D— The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| Comments of Reviewing Officials (If additional space is required, see the reverse side of this sheet) (Check box if filing extension granted & indicate number of days: _____) <input type="checkbox"/> | | | Agency Use Only: OGE Use Only JAN 21 2009 |

02

Reporting Individual's Name
 Gary Gensler

SCHEDULE A continued

Page Number
 Page 5 of 15

(Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | | |
|---|---|--|--|--|--|--|--|--|--|--|---|----------|---------------------------|--------|----------|----------|----------|----------|----------------|------------------|--|---------------------------------------|--|
| | | | | | | | | | | | Type | | Amount | | | | | | | | Other Income (Specify Type & Amount) Annex A | Date (Mo., Day, Yr.) Only if Honorary | |
| | | | | | | | | | | | Dividend | Interest | None (or less than \$201) | 0-100% | 101-200% | 201-300% | 301-400% | 401-500% | Over \$500,000 | Over \$1,000,000 | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | | |
| 1 Annabel Lee, LLC - Vanguard Emerging Markets ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 2 Annabel Lee, LLC - Vanguard European Stock ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 3 Annabel Lee, LLC - Vanguard Small Cap Index ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 4 Annabel Lee, LLC - Vanguard Total Stock Market ETF J | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Annabel Lee, LLC - New Mountain (Affiliated Investors: 3 Underlying Assets Listed Below) J | | | | | | | | | | | X | X | | | | | | | | | | \$10,800 | |
| 6 Appia Inc. (Government Technology Contracting) J 46% of capital | | | | | | | | | | | | | | | | | | | | | | | |
| 7 Overland Solutions (Outsourced Insurance Services) J 48% of capital | | | | | | | | | | | | | | | | | | | | | | | |
| 8 SXC Health Solutions J 7% of capital | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Gary Genler

SCHEDULE A continued

(Use only if needed)

Page Number:

Page 6 of 16

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Date (Mo., Day, Yr.) Only if Honorary | |
|--|---|--|--|--|--|--|-----------|---|------------------|----------------------|-------------------------|--------------------------|---------------------------|----------------|--|---|
| | BLOCK B | | | | | | | BLOCK C | | | | | | | | |
| | BLOCK B | | | | | | | Type | Amount | | | | | | | Other Income (Specify Type & Actual Amount) |
| BLOCK B | | | | | | | Dividends | None (or less than \$201) | Over \$1 - \$100 | Over \$100 - \$1,000 | Over \$1,000 - \$10,000 | Over \$10,000 - \$50,000 | Over \$50,000 - \$100,000 | Over \$100,000 | Date (Mo., Day, Yr.) Only if Honorary | |
| 1 Annabel Lee, LLC - New Mountain Affiliated Investors II - 6 Underlying Assets Listed Below | | | | | | | | | | | | | | | | |
| 2 Connections, Inc. (Healthcare) | | | | | | | | | | | | | | | | |
| 3 12% of capital | | | | | | | | | | | | | | | | |
| 4 Dolex, Inc. | | | | | | | | | | | | | | | | |
| 5 13% of capital | | | | | | | | | | | | | | | | |
| 6 Ikera Holdings, Inc. (Specialty Pharmaceuticals) | | | | | | | | | | | | | | | | |
| 7 38% of capital | | | | | | | | | | | | | | | | |
| 8 Innar Holdings, Inc. (Reverse Logistics) | | | | | | | | | | | | | | | | |
| 9 15% of capital | | | | | | | | | | | | | | | | |
| 10 Mail South, Inc. (Shared Mail) | | | | | | | | | | | | | | | | |
| 11 12% of capital | | | | | | | | | | | | | | | | |
| 12 Outlook Global Holdings, Inc. (Facilities Management) | | | | | | | | | | | | | | | | |
| 13 12% of capital | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

| Reporting Individual's Name | | SCHEDULE A continued (Use only if needed) | | | | | | | | | | Page Number Page 7 of 15 | | | | | |
|--|---|--|----------------------|-----------------------|-------------------|----------------------------|-------------------|-----------------|-----------------|-----------|---|-----------------------------|---|---|----------------------|----------------|----------------|
| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead | | | |
| | | | | | | | | | | | Type | Amount | | | | | |
| | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | Over \$1,000,000* | \$5,000,001 - \$10,000,000 | Over \$10,000,000 | Excluded Trusts | Excluded Trusts | Dividends | Interest | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$10,000 | \$10,001 - \$100,000 | Over \$100,000 | Over \$500,000 |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | |
| 1 Annabel Lee, LLC - New Mountain Affiliated Investors (Cayman) - 2 Underlying Assets Listed Below | | | | | | | | | | X | | | | | | | \$14,700 |
| 2 Paris Re Holdings Limited | | | | | | | | | | | | | | | | | |
| 19% of capital | | | | | | | | | | | | | | | | | |
| 3 Valicus Holdings, Ltd. | | | | | | | | | | | | | | | | | |
| 81% of capital | | | | | | | | | | | | | | | | | |
| 4 Annabel Lee, LLC - New Mountain Affiliated Investors III - 3 Underlying Holdings Listed Below | | | | | | | | | | X | X | X | | | | | |
| 5 Maritime Holdings (Delaware), LLC (Ocean Transport & Logistics) | | | | | | | | | | | | | | | | | |
| 31% of capital | | | | | | | | | | | | | | | | | |
| 6 Oakleaf Global Holdings, Inc. (Facilities Management) | | | | | | | | | | | | | | | | | |
| 48% of capital | | | | | | | | | | | | | | | | | |
| 7 Tygha Commercial Finance Group (Commercial Finance) | | | | | | | | | | | | | | | | | |
| 23% of capital | | | | | | | | | | | | | | | | | |
| 8 Annabel Lee, LLC - New Mountain Venture - Underlying Holdings Not Disclosed; Fund Manager does | | | | | | | | | | | | X | | | | | |
| 8 Not Revealed to Investors | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.
 Prior Editions Cannot Be Used.

Reporting Individual's Name
 Gary Gensler

SCHEDULE A continued
 (Use only if needed)

Page Number
 Page 9 of 15

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$101)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | |
|------------------------------|---|--|--|--|--|--|-------------------------------|---|---------------------|----------------------|----------------|------------------|------------------|-------------------|---|-------------------|-------------------|-----------------------|------------------|
| | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | Type | Amount | | | | | | Other Income (Specify Type & Actual Amount) | Only if Irregular | | | |
| | | | | | | | | | | | | | | | | | | | |
| | | | | | | | None <input type="checkbox"/> | \$1,000 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$50,000,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$50,000,000 | Over \$1,000,000 | Over \$5,000,000 |
| 1 | | | | | | | | | | | | | | | | | | Board Fees \$80600 | |
| 2 | | | | | | | | | | | | | | | | | | Board Fees 36500 | |
| 3 | | | | | | | | | | | | | | | | | | Board Fees 70000 | |
| 4 | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

63

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | |
|--|---|--|--|--|--|--|--|--|--|--|---|--------|--|--|--|--|--|--|--|--|---|---|
| | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | Type | Amount | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Monocentric |
| | | | | | | | | | | | | | | | | | | | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | |
| 1 DC1 Beta Trust - Vanguard Tax Exempt Money Market Fund | A | | | | | | | | | | | | | | | | | | | | | |
| 2 DC1 Beta Trust - Vanguard Emerging Markets ETF | X | | | | | | | | | | | | | | | | | | | | | |
| 3 DC1 Beta Trust - Vanguard European Index ETF | | | | | | | | | | | | | | | | | | | | | | |
| 4 DC1 Beta Trust - Vanguard Total Stock Market Index ETF | | | | | | | | | | | | X | | | | | | | | | | |
| 5 DC2 Beta Trust - Vanguard Tax Exempt Money Market Fund | X | | | | | | | | | | | | | | | | | | | | | |
| 6 DC2 Beta Trust - Vanguard Emerging Markets ETF | X | | | | | | | | | | | | | | | | | | | | | |
| 7 DC2 Beta Trust - Vanguard European Index ETF | | | | | | | | | | | | | | | | | | | | | | |
| 8 DC2 Beta Trust - Vanguard Total Stock Market Index ETF | | | | | | | | | | | | X | | | | | | | | | | |

This category applies only if the asset/income is solely that of the filer's spouse or dependent child. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name

Gary Gensler

SCHEDULE A continued

Page Number

Page 11 of 16

(Use only if needed)

| BLOCK A | BLOCK B | | | | | | | BLOCK C | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | |
|--|--|------|------------------|----------------|----------------|----------------|---------------|---------|----------|----------|--------------------------|------------------|----------------|----------------|---|--|----------------|
| | Valuation of Assets at close of reporting period | None | Over \$1,000,000 | Over \$500,000 | Over \$250,000 | Over \$100,000 | Over \$50,000 | None | Dividend | Interest | None (if less than \$20) | Over \$1,000,000 | Over \$500,000 | Over \$250,000 | | | Over \$100,000 |
| 1 DC3 Alpha Trust - Vanguard Tax Exempt Money Market Fund DC | x | | | | | | | | | | | | | | | | |
| 2 DC3 Alpha Trust - Vanguard Emerging Markets ETF DC | x | | | | | | | | | | | | | | | | |
| 3 DC3 Alpha Trust - Vanguard European Index ETF DC | | | | | | | | | | | | | | | | | |
| 4 DC3 Alpha Trust - Vanguard Total Stock Market ETF DC | | | | | | | | | | | x | | | | | | |
| 5 DC1 - Israel Bond DC | x | | | | | | | | | x | | | | | | | |
| 6 DC2 - Israel Bond DC | x | | | | | | | | | x | | | | | | | |
| 7 DC3 - Israel Bond DC | x | | | | | | | | | x | | | | | | | |
| 8 Bank of America Checking Account DC | x | | | | | | | | | | x | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name: **Gary Genster** Page Number: **Page 13 of 15**

SCHEDULE C

Part I: Liabilities
 Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your personal residence unless it is rental out; loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

| None <input checked="" type="checkbox"/> | Category of Amount or Value (\$) | | | | | | | | | |
|--|----------------------------------|------------------|-------------------|-------------------|---------------------|-----------------------|-----------------------|------------------------|-----------------|------|
| | \$10,001 - 50,000 | 50,001 - 100,000 | 100,001 - 250,000 | 250,001 - 500,000 | 500,001 - 1,000,000 | 1,000,001 - 2,500,000 | 2,500,001 - 5,000,000 | 5,000,001 - 10,000,000 | Over 10,000,000 | None |
| Examples: | | | | | | | | | | |
| 1 | | | | | | | | | | |
| 2 | | | | | | | | | | |
| 3 | | | | | | | | | | |
| 4 | | | | | | | | | | |
| 5 | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements
 Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits.

| None <input type="checkbox"/> | Status and Terms of any Agreement or Arrangement | | Party | Date |
|-------------------------------|--|---|-------------------|------------------------------------|
| | Examples: | Partners in partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/00. | | Doc Jones & Smith, Hometown, State |
| 1 | I had been fully vested under a Goldman Sachs Pension Plan, a defined benefit pension plan. My accrued benefit payable as a single life annuity at age 65 starting in 2022 is approximately \$6700 per year. | | Goldman Sachs | 11/86 |
| 2 | Upon resignation and consistent with its policy, Strayer Education will accelerate the vesting of my restricted stock. | | Strayer Education | 1/09 |
| 3 | | | | |
| 4 | | | | |
| 5 | | | | |
| 6 | | | | |

Prior Editions Cannot Be Used

67

71 of 122

| | | |
|---|-------------------|------------------------------|
| Reporting Individual's Name Gary Genster | SCHEDULE D | Page Number Page 14 of 15 |
|---|-------------------|------------------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|--|----------------------|---------------|-----------------|---------------|
| Examples: | Natl. Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6/92 | Present |
| | Doc Jones & Smith, Hometown, State | Law firm | Partner | 7/83 | 1/00 |
| 1 | See Attachment | | | | |
| 2 | | | | | |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate
 None

| | Source (Name and Address) | Brief Description of Dates |
|-----------|---|---|
| Examples: | Doc Jones & Smith, Hometown, State | Legal services |
| | Moore University (client of Doc Jones & Smith), Moseystown, State | Legal services in connection with university construction |
| 1 | New Mountain Capital | Advisory Board Service |
| 2 | Strayer Education | Board Service |
| 3 | WageWorks | Board Service |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used.

68

72 of 122

SF 278
Schedule D Part 1
Positions Held Outside US Government

- a. Annabel Lee, LLC; Family Investment Company, Managing Member, 2005 to present
- b. The Baltimore Museum of Art; Non-Profit Museum, Trustee, 2001 to 2007
- c. The Bryn Mawr School; Non-Profit Education, Trustee, 2002 to 2008
- d. East Baltimore Development, Inc.; Non-Profit Community Development Organization, Director, 2003 to 2007
- e. Enterprise Community Investments; For-Profit Community Development Organization, Director, 2001 to 2008
- f. Enterprise Community Partners; Non-Profit Community Development Organization, Trustee, 2001 to present
- g. Francesca Danieli Revocable Trust; Deceased Spouse's Testamentary Trust, Trustee, 2005 to present
- h. Gensler Family Trust; Irrevocable Family Trust, Trustee, 2006 to present
- i. Johns Hopkins Center for Talented Youth; Non-Profit Education, Advisory Board Member, 2003 to present
- j. New Mountain Capital; For-Profit Private Equity Firm, Advisory Board Member and investor, 2001 to present
- k. The Park School of Baltimore; Non-Profit Education, Trustee, 2007 to present
- l. Robert F Kennedy Center for Justice and Human Rights; Non-Profit Foundation, Trustee, 2008 to present
- m. Strayer Education; For-Profit, Director, 2001 to present
- n. Tilles Foundation; Charitable Foundation, Trustee, 1989 to present
- o. WageWorks; For-Profit, Director, 2006 to present
- p. Washington Hospital Center; Non-Profit Health, Director, 2006 to present



February 20, 2009

The Honorable Tom Harkin
 Chairman, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

The Honorable Saxby Chambliss
 Ranking Member, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

The Petroleum Marketers Association of America (PMAA) would like to express support for the nomination of Mr. Gary Gensler to serve as Chairman of the U.S. Commodity Futures Trading Commission (CFTC).

PMAA is a leading national trade association in the petroleum industry representing 8,000 independent petroleum marketing companies. It is organized as a national federation of 47 state and regional trade associations who represent wholesalers and retailers of gasoline, diesel, heating oil, lubricants and renewable fuels. PMAA companies own 60,000 retail fuel outlets such as gas stations, convenience stores and truck stops. Additionally, these companies supply motor fuels to 40,000 independently owned retail outlets and heating oil to 7 million homes and businesses.

Over the last few years, futures markets have become disconnected from supply and demand fundamentals of the physical commodities. PMAA has communicated about this issue for three years and has testified before Congress on multiple occasions.

After a productive dialogue with Mr. Gensler, PMAA is convinced that he shares our commitment of reforming futures markets by imposing aggregate speculative position limits on energy futures across all contract markets at the control entity level, to prevent excessive speculation and manipulation; closing all loopholes in current law including the "swaps loophole" and the "London loophole;" encouraging mandated clearing of most over-the-counter products; reviewing all bona fide hedge exemptions; and finally, increasing staff levels and resources at the CFTC.

PMAA strongly supports the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of law and accountability. Reliable futures markets are crucial to the entire petroleum industry and the American economy.

We appreciate your consideration, and we hope that you and your Senate colleagues will act swiftly to confirm Mr. Gensler to serve as Chairman of the U.S. CFTC.

Sincerely,

A handwritten signature in black ink, appearing to read 'Dan Gilligan', is written over a light blue horizontal line.

Dan Gilligan
 PMAA President

Petroleum Marketers Association of America, 1901 North Ft. Myer Drive - Suite 500 Arlington VA, 22209
 Tel: (703) 351-8000 info@pmaa.org



U.S. Commodity Futures Trading Commission
 Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581
www.cftc.gov

Michael V. Dunn
 Acting Chairman

(202) 418-5070
 (202) 418-5072 Facsimile
mdunn@cftc.gov

February 23, 2009

The Honorable Tom Harkin
 Chairman, Committee on Agriculture,
 Nutrition and Forestry
 United States Senate
 Washington, DC 20510

The Honorable Saxby Chambliss
 Ranking Member, Committee on
 Agriculture, Nutrition and Forestry
 United States Senate
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

I am pleased to write to you in support of the nomination of Gary Gensler to serve as Chairman of the Commodity Futures Trading Commission.

Since his nomination, I have met Mr. Gensler on several occasions. Mr. Gensler, in my opinion, has done an outstanding job of studying the issues and concerns that the Commission currently faces. Not only does he have a good understanding of the issues, he has indicated that he is ready to set a course of action that will enhance the ability of the Commission to address these issues.

Futures industry participants, consumers and Congress have called for the CFTC to provide greater transparency, accountability and oversight of the commodity markets. From meetings with Mr. Gensler and reviewing his recent communications with members of Congress, I believe that his leadership will guide the CFTC to answer these calls.

We are at a critical time in financial regulatory reform. The new Administration is making decisions on how best to craft a regulatory regime that addresses our current financial crisis. It is imperative that the CFTC be a full partner in these deliberations. This can best be accomplished by confirming President Obama's choice for permanent Chairman of the CFTC as soon as possible.

Thank you for your consideration.

Sincerely,

Michael V. Dunn
 Michael V. Dunn
 Acting Chairman,
 Commodity Futures Trading Commission

QUESTIONS AND ANSWERS

FEBRUARY 25, 2009

QUESTIONS SUBMITTED BY CHAIRMAN TOM HARKINRegulation of over-the-counter derivatives

In your written testimony you addressed the urgent need to develop a broad regulatory regime for over-the-counter derivatives, stating that, "Standardized derivatives should be brought into mandated centralized clearing and onto exchanges." Your testimony suggests that customized bilateral swaps would not necessarily need to be centrally cleared or traded on exchanges. I am concerned that if we allow commercial interests to continue to enter into bilateral swaps, and to avoid exchange trading or clearing simply through what might be minor custom features in contracts, we will allow a loophole that will seriously jeopardize our efforts to restore derivatives trading to the full scrutiny and integrity of regulated exchange trading and centralized clearing. Hence your testimony draws a distinction between standardized derivatives and customized bilateral swaps, but that begs the question how to go about distinguishing between those two categories of derivative contracts, since the terms do not have obvious, set definitions and the consequences of drawing this distinction are critical.

Without necessarily prescribing a specific proposed rule, would you please explain what in your view are relevant and appropriate considerations, criteria, and approaches which should be weighed in drawing the distinction or division between standardized derivatives contracts and truly customized, individualized swaps contracts?

United States Enrichment Corporation

I understand that when you served as Assistant Secretary of Treasury for Financial Markets, Secretary Rubin delegated to you the responsibility to supervise and approve privatization of the United States Enrichment Corporation (USEC). The sale of USEC was supposed to be conditioned on specific statutory requirements, most of which proved not to have been met as subsequent events unfolded.

First, the proceeds from privatization were supposed to at least equal the net present value of the Corporation. Although the proceeds from the sale may have met this test, when the sales proceeds of \$1.8 billion were reduced by the \$325 million expenditure to buy Russian uranium and the \$381 million cost to put the Ohio plant on cold standby, the United States lost money from this transaction.

Second, the sale was not supposed to jeopardize either the health and safety of the public or the common defense and security of the country. In fact, shortly after privatization, the price

of uranium collapsed and Russia suspended shipments of uranium to the United States. Russia's continued participation in the nonproliferation of nuclear material agreement was critical to this country's national security. The Department of Energy had to step in and purchase uranium from the Russians at above market prices to preserve the nonproliferation agreement.

Third, the sale was conditioned on a reasonable assurance that adequate enrichment capability would remain in the United States to meet the demands of the domestic electric utility industry and on the continued operations of the Department of Energy's two gaseous diffusion plants through December 31, 2004. In fact, only 25 percent of the nuclear industry's fuel requirements are met from domestic sources and USEC closed the Ohio uranium enrichment plant in 2001.

Fourth, privatization was supposed to provide for the long term viability of the enrichment corporation. The corporation has a minimal credit rating of CCC.

Fifth, privatization was supposed to protect the public interest in maintaining a reliable and economical domestic source of uranium mining, enrichment, and conversion services and industries. When USEC sold off its uranium inventory to raise cash, uranium prices collapsed leading to the closure of uranium mines, and U.S. uranium output. Conversion services and industries suffered collateral damage from the reduction in U.S. uranium production.

Please respond to each of these points to justify your recommendation in July of 1998 that Treasury approve the 1998 privatization of the United States Enrichment Corporation.

Divergence between cash and futures prices in agricultural commodities

For the past two years, the prices of the wheat futures contract on the Chicago Board of Trade have failed to converge with cash prices at the expiration of the futures contracts. It is not entirely clear why this market has not demonstrated reasonable convergence, but it suggests that the futures contract is not functioning as it should. This lack of convergence creates problems for farmers, grain elevators, grain merchants, and processors who rely on futures markets to hedge grain prices.

What would you see as the CFTC's role in taking corrective action so the situation is not prolonged further and cash basis returns to more normal levels?

Will you pledge to follow up if confirmed and devote your personal attention to this problem of lack of convergence in futures and cash prices?

Role of index funds in futures prices

Many traditional participants who use the futures markets to hedge their price and inventory risk believe that a large influx of investment capital into the futures markets contributed to artificially high futures prices.

As Chairman of the CFTC, what steps would you take to help ensure that futures markets work for the intended users and that the price discovery function is not distorted by investment capital?

Position limits

In your statement, you comment that increased speculation in energy and agricultural products has hurt farmers and consumers and that position limits must be applied consistently to all markets and trading platforms and exemptions to them must be limited and well-defined. Under current CFTC practice, swaps dealers and index funds have been allowed to claim exemptions from position limits to hedge financial risk.

Would you support position limits that apply to all traders with the only exemptions for those with a bona fide risk in the cash market for a physical commodity? If not, why not?

Senator Sherrod Brown
Question for the Record for Gary Gensler

1. The privatization of United States Enrichment Corporation (USEC) raises significant questions. USEC was sold despite the fact that most of the conditions for the sale were unmet. Today, the company continues to rely on the government. You played an integral role in the privatization. Can you explain why the sale took place despite the failure to meet the conditions of the sale?
2. The failure to fulfill promises on the conditions that attached to the sale was not the last broken promise in connection with USEC. The plant in Piketon Ohio did not remain open until 2005, contrary to the agreement, and pensioners have been denied the COLAs they were promised. All the while, the United States share of the domestic uranium market continues to dwindle.

Was the privatization a mistake? Would you go about it again knowing what you know now? What would you have done differently?

3. In your role as an Undersecretary at the Treasury Department, you worked on the 1999 report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act. Given the regulatory failures of the past two years, what part of that report would you change?
4. In your capacity as an Undersecretary at the Treasury Department, what was your involvement with the enactment of the Commodity Futures Modernization Act of 2000? Have your views changed since that time regarding the need for regulation of over-the-counter swaps and derivatives by CFTC?
5. If confirmed as Chairman of the CFTC, would you support some form of mandatory clearinghouse for all over-the-counter (OTC) derivatives? This would allow regulators to fully view all OTC transactions, unlike the opaque environment that exists presently, to determine if they are adversely affecting the market's price-discovery function.
6. In your opinion, what has been the role of excessive speculation in creating unwarranted fluctuations in commodity prices? Do you support position limits on all traded commodities, regardless of where they are executed, to eliminate excessive speculation in these markets? If you would not, why not?

**Senator Bob Casey
Questions for the Record**

Oil Speculation

There has been a lot of debate about the impact of speculation and futures contracts on the price of oil. What is your view on the excessive speculation contributing to oil prices that would not normally be supported by the market? And what do you think the role of the CFTC should be in determining and overseeing speculation that is "excessive"?

CFTC Modernization

What do you think of proposals to combine the CFTC and the Securities Exchange Commission into a combine oversight authority that will regulate derivatives contracts and credit default swaps?

Public Confidence

Government has a lot of work to do in order to rebuild confidence in our ability to oversee markets and protect the public interest. What would you do as the chairman of the CFTC to rebuild that public trust and provide oversight, transparency and accountability?

**Statement of Senator Charles E Grassley
Nomination of Gary S. Gensler
to be Chairman of the Commodity Futures Trading Commission (CFTC)
February 25, 2009**

First off, I want to congratulate you Mr. Gensler on your nomination by President Obama to the Commodity Futures Trading Commission. The nomination in and of itself is a great honor and I welcome you here to the committee.

I want to start by thanking both Walt Lukken and Michael Dunn for their service as Acting Chairmen. I know this has not been an easy position to fill recently and I want to acknowledge their willingness to serve in this capacity.

The last year of events has taken a toll on both our economy and the morale of the American people. But that doesn't mean that changes we make now can't help better the situation in the future.

The CFTC has traditionally played an under the radar role, but I think that is going to change. Just by the nature of what's happening in our markets, it's time that this agency has a higher profile role.

Clearly there is a lot of disagreement about the level of problems that derivatives and credit default swaps have caused on our financial markets. And there is going to be even more disagreement about whether regulation is necessary and if so, who should be regulating these products.

This year Congress is also going to have to decide what the appropriate role of speculators is in our commodity markets. And we are going to have to decide if we are serious about giving CFTC the resources it needs to do its job effectively.

I am anxious to hear your outlook and answers on these important topics. But, I'd also like to learn more about how you believe you can separate your many years at Goldman Sachs with what will be your new responsibilities at CFTC.

Again, welcome to the committee and congratulations on your nomination.

Questions:

- 1) Do you believe there is evidence that crude oil prices were being driven by speculators last year? If so, what do you believe is the CFTC's responsibility with regard to limiting the amount of institutional speculation?
- 2) Do you think that the CFTC has acted aggressively enough to determine the impact of institutional investors and speculators on commodity markets?
- 3) Does CFTC currently have all the tools necessary to respond to the speculation in commodities by hedge funds, investment banks and pension funds? Does Congress need to act to provide additional authority to the CFTC? If so, please provide specific recommendations for additional authority.

- 4) When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?
- 5) Do you believe that further oversight of commodities trading is needed in light of the increased pressure on margin calls and market volatility that led to local elevators and major grain trading companies not being able to offer forward contracts to producers last summer?
- 6) In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 last summer. Now it's under \$40. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/3 of the original price?
- 7) It's been reported that you actually advocated exempting derivatives and credit default swaps from regulation when you were in the Clinton Administration at Treasury. Do you still feel the same way?
- 8) What do you believe is the appropriate oversight of derivatives? Which federal agency should have oversight responsibilities of these contracts?

Senator Ben Nelson
Questions for the Record
Nomination of Gary Gensler, Chair CFTC
February 25, 2009

Questions:

- (1) Last September, CFTC issues a staff report on Commodity Swap Dealers and Index Traders. While this report was generally deficient and continued CFTC's inability or unwillingness to see problems in the market, it did contain one very valuable recommendation that I would like to ask you to follow-up on. The report recommended a review of "whether to eliminate the *bona fide* hedge exemption for Swap Dealers and replace it with a new limited risk management exemption" subject to certain conditions. Specifically, CFTC staff was instructed to develop an advanced notice of proposed rulemaking for this purpose. Do you know whether that recommendation has been followed and whether the rulemaking will be forthcoming (and when)? If it has not been followed, do you have any intention of seeing that it is?
- (2) What are your views regarding mandatory clearing on an exchange for all over-the-counter (OTC) derivatives particularly the physical commodities including energy, energy products, and agriculture?
- (3) What are your views regarding the imposition of strong position limits on all traded physical commodities – including energy and agriculture – for all speculators, regardless of where they execute their orders – OTC, on exchange, or elsewhere – to eliminate excessive speculation in these markets?

Senator Pat Roberts
 Senate Agriculture Committee
 Statement and Questions for the Record
 Nomination Hearing of Mr. Gary Gensler
 CFTC Chairman
 February 25, 2009

Mr. Gensler, first, thank you for meeting with me several weeks ago. You travel in good company with Senators Sarbanes, Mikulski and Cardin at your side. In reading through your statement and subsequent responses to questions not only from members of this committee but several of our colleagues in the Senate, I think it's fair to say you have an in depth knowledge of the trading instruments used today in the marketplace.

I don't think you'll find much disagreement that based on recent history the CFTC and our other financial regulators need improvements; be that either investments in resources or policy authority. The debate will be over how much of both.

1. It is the nature of Congress to over-react. When the marketplace is over-regulated, Congress historically loosens the ~~reigns~~ too much. When the marketplace is under-regulated, Congress pulls the reins in too tightly. I think it's obvious we are coming through a period where those reins have been too loose.

reins

However; as we move forward on legislative proposals, we will look to you and your fellow commissioners to guide us on how to pull those reins back in at an appropriate level without repeating mistakes of the past. How do you suggest we find that equilibrium between regulations that protect all market participants, producers, and the public with those that provide the flexibility necessary for commerce to grow and evolve?

2. Some of the talk around here has been whether CFTC and SEC should merge. Many of my constituents are fearful that such a merger would result in the loss of expertise in the agricultural market regulators. How do you feel about proposals for a merger?

3. Members of this committee know all too well that futures prices fluctuate. This fluctuation has encouraged our producers to become not just "sellers" of their crops but "marketers." Successfully marketing one's crop helps hedge against price fluctuations and can bring stability to an operation's bottom line. But this growing practice depends upon a sound, transparent market that is free from manipulation. As head of the CFTC, what will you do to ensure that our agriculture producers are both protected and yet able to fully utilize the benefits of the futures markets?

4. Last year, Acting CFTC Chairman Lukken and SEC Chairman Cox signed a Memorandum of Understanding to work cooperatively on outstanding issues. Do you plan to honor the process outlined in that MOU? Is there another process which would be preferable to this MOU process?

5. In your statement, you advocate for mandatory clearing of all standardized derivatives contracts. You go on to support establishing a regulatory regime for customized contracts as well but not mandated clearing. Some legislative proposals being debated today would mandate that all Over-The-Counter derivative contracts go through a centralized clearinghouse. What concerns if any do you have with this proposal for mandatory clearing of all OTC derivatives contracts?

Senator Stabenow
Questions for the Record – Gary Gensler
February 25, 2009

We have often heard that one of the problems that occurred during the run up in commodities last year was that the CFTC did not have access to enough data concerning all market participants.

- Are you concerned with over-the-counter markets, which the CFTC has limited data and oversight over? Do you believe that a window is needed into off-exchange markets?
- Along those lines would you support requiring the CFTC to adopt rules defining and classifying index and swap traders for the purpose of data reporting? If so, how would you go about doing this and in your opinion who would constitute "index traders?"

The Commodity Futures Modernization Act was passed in 2000, which among other things, restricted the ability of the CFTC and the SEC to regulate swaps, including credit default swaps which have played a role in our current crisis.

- Do you support re-regulating over-the-counter derivatives and if so what do you think is the appropriate framework for regulation?
- Do you believe that there should be a requirement to clear or to transact on exchange all derivatives--even those that are not standardized and liquid?
- How do we achieve transparency for participants and regulators but not eliminate the markets or send them overseas?

February 11, 2009

The Honorable Maria Cantwell
United States Senator
511 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Cantwell:

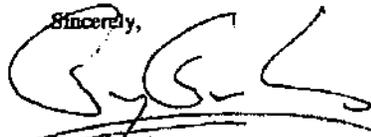
I am writing in response to your series of questions regarding my nomination to be Chairman of the Commodity Futures Trading Commission. I appreciate your meeting with me on January 15 and your leadership on the many issues facing the Commission. Please find my responses attached.

I believe the CFTC must vigorously fulfill its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation.

We also are at a transformational time that requires bold leadership to strengthen our regulatory system. The American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to repair our regulatory system and to enact far-reaching rules that promote transparency, accountability, fairness, and safety.

If confirmed by the Senate, I look forward to working with you on much needed regulatory reform. I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. Furthermore, I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace.

Should you have further questions, please do not hesitate to contact me.

Sincerely,

Gary Gensler

Please Explain your work at the Treasury Department

1. **In your capacity as an Undersecretary at the Treasury Department, you worked on the November 1999 Report of the President's Working Group on Financial Markets report on *Over-the-Counter Derivative Markets and the Commodity Exchange Act*. What specific part, if any, of this report do you disagree with today?**

We have learned a great deal in the nearly ten years since the President's Working Group on Financial Markets' report was published. Capital markets have been transformed by new financial products, the increased use of asset securitizations and 'off balance sheet' financings, the development of fully electronic markets, the significant participation of index and hedge fund investors in commodity markets, and other financial and technical innovations. We also have witnessed the harsh aftermath of Wall Street's excess leverage and risk taking, mortgage originators' weak underwriting practices, and rating agencies' shortcomings. Our financial system and our regulatory system both have failed the American people.

I believe that we must move swiftly now to apply the hard lessons we have learned. We must repair our regulatory system and enact far-reaching rules that promote transparency, accountability, fairness, and safety. To be effective regulations must adapt and stay abreast of developing technologies and new products. I firmly believe that the American public and our economy benefit from strong, intelligent regulation.

First, we must ensure that the CFTC is revitalized in order to vigorously enforce existing laws and fulfill its mandates: to promote market integrity, to prevent fraud and manipulation, and to guard against excessive speculation.

Second, we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. I believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe we must increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

Third, we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers,

formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Finally, as this crisis has powerfully demonstrated, we must work more closely with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We need to ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors that we will demand of our markets. If confirmed, I look forward to working with Congress and international regulators to achieve these goals.

- 2. As an Assistant Secretary and Under Secretary of Treasury in 1998-2001, did you oppose the regulation of over-the-counter swaps and derivatives by the CFTC? What specific actions did you take in this regard?**

During 1998, I was not involved in these matters, which occurred primarily during the spring and summer. This was during my first year at the Treasury Department and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer. The subsequent drafting and passing of the Commodity Futures Modernization Act (CFMA) legislation was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, the SEC, the CFTC and the Treasury Department. Hearings were held in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in 2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury and the Administration's positions.

- 3. In your capacity as an Undersecretary at the Treasury department, did you work to enact the Commodity Futures Modernization Act of 2000 (CFMA) which specifically exempted swaps from CFTC regulation? Did you intend to exempt credit default swaps from regulation as part of the CFMA?**

I was a member of a team that worked with and advised then-Treasury Secretary Summers on Treasury and the Administration's positions. At the time, the vast majority of over-the-counter derivative contracts were interest rate and currency swaps, constituting 97% of the market. These swaps made up 29 out of 30 derivative transactions in those days. The bulk of those remaining were equity and commodity derivatives transactions. Credit default swaps were an insignificant product at the time and not a focus during the legislative process.

- 4. Do you still support the policy to exempt swaps from regulation by the CFTC? Has your opinion changed?**

As I have previously stated, I believe we must enact a broad regulatory regime for the over-the-counter derivatives marketplace that promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

5. To what extent to you believe the enactment of the CFMA contributed to the current financial sector crisis?

I believe that both our financial system and our regulatory system failed the American people. There were many elements that contributed to these failures. To repair and reform the system, we must apply the hard lessons we have learned and tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for investors, consumers, and farmers.

I believe we must enact a broad regulatory regime for the over-the-counter derivatives marketplace. If confirmed by the Senate, I look forward to working with Congress, the Administration, and other regulators to amend the Commodities Exchange Act and create regulatory oversight for the over-the-counter derivatives market that best promotes transparency, accountability, and safety.

6. To what extent is unregulated trading in credit default swaps responsible for the current financial crisis?

I believe that many factors contributed to the current financial crisis. One of the significant lessons we have learned is that unregulated derivatives dealers, many of which were affiliates of broker dealers, threatened and in some cases destroyed their parent or affiliate, causing global shockwaves.

This was the case in AIG's failure, for example. AIG, a leading global insurance company, with many state regulated insurance subsidiaries, had an unregulated capital markets and derivatives affiliate, AIG Financial Products. This unregulated affiliate developed a significant credit default swap business. By June, 2008, they reported having a \$447 billion net notional amount of credit default swaps. Approximately two thirds of this was written to support regulatory capital of major banks, primarily in Europe. The other third was written largely in support of asset securitizations. Regulators failed to institute appropriate oversight for this unregulated dealer and others like it. Global regulators also failed to keep pace with this new and rapidly growing market, and systematically serious consequences resulted.

While serving at the Treasury Department as the Under Secretary for Domestic Finance in the late 1990's, as part of the Treasury team, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. I feel even more strongly that this is the right course of action today. If confirmed by the Senate, a high priority for me will be working with Congress and other regulators on a statutory and regulatory framework for all derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

Furthermore, if confirmed by the Senate, I look forward to working with Congress on considering further regulations for credit default swaps. This would be in addition to bringing all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establishing a statutory and regulatory framework for derivatives dealers, and formulating appropriate oversight for bilateral customized derivatives. Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps also were used by some banks to manage their bank capital requirements and to structure asset securitizations. Given these unique characteristics of credit default swaps, I believe multi-agency regulatory review and cooperation will be necessary in working with Congress to design possible new federal regulations specific to these products.

7. Do you believe all credit default swaps should be subject to mandatory clearing on a prospective basis? Or do you prefer a policy of voluntary clearing?

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing. As I have discussed above, I believe that further regulations for credit default swaps should be considered in addition to bringing all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establishing a regulatory framework for derivatives dealers, and formulating appropriate oversight for bilateral customized derivatives.

8. Should existing credit default swaps be subject to mandatory clearing?

I believe this is an important issue not only with regard to credit default swaps, but for all outstanding over-the-counter derivatives. Bringing standardized over-the-counter derivatives into mandated centralized clearing could ensure for the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Most existing over-the-counter derivatives contracts, however, were entered into on a bilateral basis. In addition, a review of publicly available data suggests that the majority of outstanding mark-to-market exposures for derivatives dealers have not been fully

collateralized. To do so would require significant additional resources and capital for the major banks.

If confirmed by the Senate, I look forward to working with Congress and other regulators to consider this important question and how to best achieve the benefits that mandated centralized clearing of existing over-the-counter derivatives could provide.

9. Which agency should Congress designate as the regulator of organizations which will clear credit default swaps: the CFTC, the Securities and Exchange Commission (SEC) or the Federal Reserve?

The CFTC has a well established record of successfully overseeing and regulating derivatives clearing organizations in the US. In my view, this experience makes the CFTC best suited for overseeing central counterparty clearing of credit default swaps.

10. Should credit default swaps be regulated as insurance? If so, should this be state based regulation or federal regulation?

Some credit default swaps have insurance-like characteristics. For example, AIG Financial Products, the unregulated affiliate of AIG discussed above, was writing credit protection for European banks and asset securitizations. This shared many characteristics with the bond insurance protection being written at the same time by monoline financial guarantee insurers like MBLA and AMBAC. Given this and other unique characteristics of credit default swaps, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new federal regulations for these products.

11. What is the social benefit from naked credit default swaps (e.g. the entity does not own the property that is covered by the swap but is simply speculating on the failure of an institution or governmental unit)? Should "naked" credit default swaps be outlawed altogether? If not, why not?

Naked credit default swaps, particularly those related to single issuers, have many attributes of a short sale of a corporate bond. Approximately half of the current credit default swap marketplace relates to single-issuer credit default swaps. Congress is currently considering legislation that would ban naked credit default swaps. If confirmed by the Senate, I look forward to working with Congress and other regulators to consider how to best protect against manipulation and market abuse that may result from trading in naked credit default swaps.

Please explain oil prices and the CFTC's regulatory response in 2008

12. What is your explanation for why oil prices increased from about \$90 per barrel in December 2007 to about \$150 per barrel in July 2008, to fall to less than \$40 today? To what extent was speculation by large banks and index investors in swaps or futures responsible for a portion of the run up?

I believe that rapid growth in commodity index funds was a contributing factor to a bubble in commodities prices that peaked in mid-2008. The expanding number of hedge funds and other investors who were increasing asset allocations to commodities within their portfolios also put upward pressure on prices.

If confirmed by the Senate, I look forward to working with Congress to take a fresh look at the role of speculation in the commodity futures markets.

13. How would you have used the regulatory tools available to the CFTC differently than the CFTC did this year to address the unprecedented spike in oil prices?

Guarding against excessive speculation and market manipulation are two core functions of the CFTC's oversight responsibility. If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current hedge exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

I believe that the CFTC could have been more vigilant in guarding against excessive speculation in the commodities futures markets. The CFTC has used no-action letters for important regulatory decisions such as allowing foreign boards of trade direct access to US customers and granting hedge exemptions. These no-action letters have had consequential effects on the Commission's regulatory programs. If confirmed by the Senate, I would undertake a thorough review of the process and standards for which matters come to the Commission and through which no-action letters are issued.

I also believe that the CFTC should promote greater transparency by providing more useful and comprehensive data to the public. For example, the CFTC currently provides weekly "Commitments of Traders" reports (COT's), which show large position interests in certain commodities subject to CFTC oversight. These published reports are segmented into "commercial" and "non-commercial" positions and in some cases, nearly 90% of reported open interests are held by non-commercial traders. I believe we could promote greater transparency and market integrity by providing a further breakdown of non-commercial open interests. If confirmed by the Senate, I will work with the CFTC staff to use the tools at our disposal to protect consumers, investors, and farmers by promoting transparency through more sophisticated data collection and dissemination.

*The Commodities Futures Modernization Act of 2000***14. Do you agree that it was prudent to provide "legal certainty" as part of the CFMA to exempt swaps from CFTC regulation?**

We have learned a great deal since that time. Capital markets have been transformed and we have witnessed the harsh aftermath of Wall Street's excesses. I firmly believe that the American public and our economy benefit from strong, intelligent regulation. To be effective, though, regulations must adapt and stay abreast of developing technologies and new products. We must move swiftly now to apply the hard lessons we have learned. We must better protect investors, consumers, and farmers by reforming our regulatory system and enacting far-reaching rules that promote transparency, accountability, fairness, and safety and ensure a crisis of this severity does not happen again.

I believe we must enact a broad regulatory regime for the over-the-counter derivatives market. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Regarding the 'legal certainty' of over the counter derivatives, this issue had been discussed since the establishment of the CFTC in 1974. Since that time, bilateral over-the-counter derivatives entered into between institutional counterparties had not been regulated by the CFTC. This was based upon a combination of the statutory language of the Commodities Exchange Act setting up the CFTC, subsequent Congressional actions, CFTC interpretations and policy statements, case law, and regulatory practice. For instance, in 1974, Congress incorporated the 'Treasury Amendment,' which exempted from CFTC regulation transactions in foreign currencies, government securities, mortgage securities, and certain other debt instruments. Later, in 1989 the CFTC Swaps Policy Statement was issued, followed in 1992 by the Futures Trading Practices Act and subsequently, in 1993, both the CFTC Swaps Exemption and Forward Contract Exemption were issued. One of the principal goals of the 2000 legislation was to provide further legal certainty under the CEA for the then existing regulatory practice.

15. Would you support a complete repeal of the CFMA?**16. If not, what specific part of the CFMA would you repeal?**Answer to 15 & 16

I believe there are many areas where the Commodities Exchange Act should be amended and improved.

In particular, I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets and enact a broad regulatory regime for the over-the-counter derivatives marketplace that promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

I also believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. If confirmed by the Senate, I look forward to working with Congress to achieve this objective.

I believe we must also reform regulation of the over-the-counter derivatives market. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Bringing all standardized over-the-counter derivatives into mandated centralized clearing could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, enhance the price discovery function, and provide additional safeguards for investors.

I believe we must establish a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps were used also by some banks to manage their bank capital requirements and to structure asset securitizations. Given these factors, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new regulations for these products.

17. What part of the economy is better off today because of the CFMA?

We are struggling through a time of unprecedented economic turmoil. The challenges cannot be overstated. I believe that both our financial system and our regulatory structure failed the American people. Many elements contributed to these failures and we have learned a great deal.

I firmly believe that the American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to reform and amend the Commodities Exchange Act to better protect investors, consumers, and farmers by reforming our regulations and enacting far-reaching rules to ensure a crisis of this severity does not happen again.

Do you support strong regulatory authority and closing ALL loopholes? Please answer the following questions yes or no.

18. Eliminating exemptions and exclusions: Eliminate the over the counter market exemptions by requiring all future transactions, including credit default swaps, to not only be subject to clearing, but to be conducted on fully regulated exchanges

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing and onto exchanges. I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Furthermore, I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

19. London Loophole: Require all Foreign Boards of Trade that solicit or accept more than a certain level of the business volume from the U.S. to register as fully regulated domestic exchanges and thus be ineligible for "no action" letters?

I support the CFTC's 2008 actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations applied to U.S. exchanges. Furthermore, I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits. If confirmed by the Senate, I look forward to working with Congress to codify the CFTC's authority to promulgate regulations

regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

20. *Enron Loophole:* Eliminate Exempt Commercial Markets as an eligible registration class and require existing Exempt Commercial Markets to register as fully regulated exchanges like a Designated Contract Market or a Designated Transaction Execution Facility?

I believe that the "Enron Loophole" should be closed and that uniform standards must be applied to contracts for physical commodities that have the same practical pricing effects, as called for in the 2008 Farm Bill. As I have stated previously, I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act.

21. *Aggregate Speculation Limits:* Set aggregate speculative position limits on energy and agriculture futures across all contract markets at the control or ownership level?

I believe the CFTC should examine ways to set aggregate speculative position limits on energy and agriculture futures across all contract markets at the control or ownership level.

22. *Manipulation Standard:* Strengthen the Commission's anti-manipulation authority from a "specific intent" burden to a "recklessness" burden bringing the CFTC more in line with the SEC, Federal Energy Regulatory commission (FERC), and the Federal Trade Commission (FTC)?

Currently, because of recent grants of anti-manipulation authority by Congress to the FERC and FTC based upon SEC case law, there is the possibility that the same set of actions in a market could be subject to different legal standards for manipulation depending upon the agency bringing the case.

If confirmed by the Senate, I look forward to working with Congress and other regulators to consider how to best utilize and interpret the CFTC's anti-manipulation authority to consistently protect consumers and enhance market integrity.

Increased Resources for the Commission

23. *User-Fee Model:* Adopt a futures transaction-fee model, that FERC uses and that the SEC has used since its inception, to increase available resources to the CFTC?

I believe the CFTC is significantly underfunded to simply meet its current mandates. The CFTC also lacks the necessary technology to monitor today's markets effectively. Likewise, I am concerned that the CFTC has not directed enough resources towards developing a robust staff of independent economists, whose work is essential to the Commission and Congress.

Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. Over the same time, exchange trading has grown exponentially, and the issues the CFTC faces have increased in complexity. Contracts traded or cleared on US futures exchanges have gone up nearly six-fold from 2000 to 2008. Thus, the CFTC's current resources do not seem appropriate to respond to the challenges we face or the times in which we live.

If Congress acts to expand the CFTC's mission and authority to better regulate over-the-counter derivatives markets, address excessive speculation, and increase investor protection, significant additional resources will be required.

I believe the critical issue is to find adequate resources to support the important work that lies ahead for this Commission. While I have not made an independent determination about user funding, if confirmed by the Senate, I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

FERC and FTC anti-manipulation authority – please answer the following question yes or no

24. Congress specifically modeled the FERC's and FTC's anti-manipulation authority to allow the agencies to pursue manipulative activity in the futures markets that impact transactions in the cash markets. On the basis of the CEA's "exclusive jurisdiction" provision, the CFTC has resisted FERC's utilization of this authority when pursuing manipulative activity which originated in the futures markets and impacted their jurisdictional cash markets, and has strongly opposed the FTC's rulemaking that would allow it to bring actions which span the physical and financial markets. Will you support dropping this opposition to the FERC's authority in court, and work cooperatively with both the FERC and FTC on allowing them to exercise their authorities to pursue manipulative conduct which spans the physical and financial markets? If not, why not?

If confirmed by the Senate, I would make it a high priority as Chairman to ensure the CFTC works with all other agencies effectively to prevent manipulation, protect investors, and enhance integrity in the physical and financial markets. We must ensure that we use the fullest grants of authority to pursue a robust enforcement agenda. More specifically, if confirmed by the Senate, I would meet with the Chairman of the FERC and of the FTC to find the most effective way to work together in furtherance of the public interest.

Sharing Answers

25. May I share your answers with interested colleagues?

I welcome your sharing these answers with interested colleagues and look forward to making myself available for meetings for follow up discussions.

February 11, 2009

The Honorable Dianne Feinstein
United States Senator
331 Hart Senate Office Building
Washington, DC 20510

Dear Senator Feinstein:

Thank you for your congratulations on my nomination to serve as Chairman of the Commodity Futures Trading Commission. I appreciate your interest and leadership on the many issues facing the Commission. Please find attached my responses to your specific questions.

I believe the CFTC must vigorously fulfill its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation.

We also are at a transformational time that requires bold leadership to strengthen our regulatory system. The American public and our economy benefit from strong, intelligent regulation. We must apply the hard lessons we have learned to repair our regulatory system and to enact far-reaching rules that promote transparency, accountability, fairness, and safety.

If confirmed by the Senate, I look forward to working with you on much needed regulatory reform. I believe we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. Furthermore, I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace.

I look forward to sitting down with you to discuss my nomination and the important work facing the CFTC.

Sincerely,



Gary Gensler

1. Commodity Futures Modernization Act. During your tenure as Undersecretary of the Treasury, Congress drafted the Commodity Futures Modernization Act that eliminated oversight of electronic markets – the Enron Loophole – and statutorily enshrined CFTC Chairman Wendy Graham’s 1992 regulatory decision to exempt all bilateral swaps from CFTC oversight.

- **Did you support exempting energy trading on electronic markets and bilateral swaps from CFTC oversight?**

I firmly believe that the American public and our economy benefit from strong, intelligent regulation. We have learned a great deal in the nearly ten years since the President’s Working Group on Financial Markets’ Report on derivatives was published. I believe that we must now move swiftly to revise the Commodities Exchange Act (CEA) in light of many lessons learned to best promote transparency, accountability and safety.

The President’s Working Group’s 1999 Report called for swap agreements that “involve a non-financial commodity with a finite supply” to be fully regulated under the CEA without exclusions. The subsequent drafting and passing of the legislation was a lengthy process that was unable to achieve this recommendation. The legislation also did not incorporate the recommendation for enhanced regulation of derivative dealers affiliated with broker dealers.

I feel even more strongly today that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe that we must move swiftly to enact a broad regulatory regime for the over-the-counter derivatives marketplace. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

- **What role did you play in drafting this legislation, and what was your view of these exemptions at the time?**

I was not involved during 1998, when the Treasury, Federal Reserve and SEC articulated significant policy positions on these matters. This was during my first year at Treasury and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer. The subsequent drafting and passing of the Commodity Futures Modernization Act (CFMA) was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, SEC, CFTC and Treasury Department. Hearings were held in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in 2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury and the Administration’s positions.

- **President Clinton’s Working Group on Financial Markets recommended regulation of derivative and swaps dealers and called for swaps clearing. Did**

you recommend that President Clinton support the final legislation that included neither of these financial safeguards?

I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives market that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges and to establish a statutory and regulatory framework for derivatives dealers. In addition, I would work with Congress to formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

While serving as the Under Secretary for Domestic Finance, as part of the Treasury team, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. We were unable to achieve this objective working with Congress on legislation. The hard lessons of the financial crisis further highlight that regulating all derivatives dealers is the right course of action today. If confirmed by the Senate, I look forward to working with Congress and other regulators on a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules

One of the President's Working Group's recommendations nearly ten years ago was to facilitate clearing houses for over-the-counter derivatives. I feel strongly that we must now bring all standardized over-the-counter derivatives into mandated centralized clearing. I believe that this should cover all standardized products, including interest rate, currency, equity, commodities and credit default swaps. This step could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

• Do you view the Commodity Futures Modernization Act as a mistake?

I believe that both our financial system and our regulatory system failed the American people. There were many elements that contributed to these failures and we have learned a great deal since the legislation was enacted. To repair and reform the system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, investors, and farmers.

To be effective, financial regulations must adapt and stay abreast of developing technologies, products and markets. I believe that we must now move swiftly to revise the Commodities Exchange Act (CEA) in light of many lessons learned to best promote transparency, accountability and safety.

▪ **What specific sections of this legislation do you support repealing today?**

First, we must enhance the CFTC's ability to guard against excessive speculation in commodities markets. I believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act. I also believe we must increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms. If confirmed by the Senate, I look forward to working with Congress to achieve these objectives.

Second, we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety. If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

2. Swaps regulation. Much like OTC energy derivative swaps, voice-brokered credit default swaps markets operate with no market monitoring to prevent manipulation, no clearinghouse holding collateral to back transactions, and no comprehensive records of who is trading what. Do you support repealing the "swaps loopholes" in Section 2 of the Commodity Exchange Act? Would you support legislation striking subsection (d), subsection (g) and paragraphs (1) and (2) of subsection (h) of the Act?

I believe that we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

I also believe that all physical commodities futures, including agricultural, metals and energy, should have consistent regulation under the CEA.

To achieve these goals, amending each of the referenced subsections of the CEA would be required. If confirmed, I look forward to working with Congress to achieve these objectives.

3. Enron Loophole. The 2007 Farm Bill closed the Enron Loophole by requiring electronic exchanges to actively monitor trading of significant price discovery contracts. CFTC must review electronic contracts on an ongoing basis to ensure that all

significant price discovery contracts are regulated. What will you do to ensure that CFTC's review is thorough and effective?

I believe that the "Enron Loophole" should be closed and that uniform standards must be applied to contracts for physical commodities that have the same practical pricing effects, as called for in the Farm Bill. I believe that all physical commodities, including agricultural, metals and energy, should have consistent regulation under the Commodities Exchange Act.

If confirmed by the Senate, I am committed to ensuring that the CFTC vigorously fulfills its mandates: enforcing existing laws aggressively, promoting market integrity, preventing fraud and manipulation, and guarding against excessive speculation. I believe a critical issue is finding adequate resources to support the important work required of this Commission. The CFTC is significantly underfunded to simply meet its current mandates, and its mandates are increasing. I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

4. Prevent systemic risk through a new clearinghouse. The President's Working Group on Financial Markets (PWG) has signed a memorandum of understanding to guide oversight of a credit default swap clearinghouse, but both the SEC and the CFTC have stated in testimony that their ability to regulate a swaps clearinghouse is limited by the Commodity Futures Modernization Act.

- **Do you support legislation requiring a credit default swap clearinghouse to be registered with CFTC as a Derivatives Clearing Organization?**

I support legislation requiring a credit default swap clearinghouse to be registered with the CFTC as a Derivatives Clearing Organization (DCO).

- **CFTC is the federal agency with the most substantial history of regulating clearing organizations. The Federal Reserve has the legal power to regulate clearing, but Congress has not specified regulatory principles under which the Federal Reserve would perform this regulation. Do you believe CFTC should be the lead agency overseeing swaps clearing?**

The CFTC has a well established record of successfully overseeing and regulating derivatives clearing organizations in the US. In my view, this experience makes the CFTC best suited for overseeing central counterparty clearing of credit default swaps.

- **If multiple regulators oversee different clearinghouses, would it be difficult to ensure that any one regulator would have a comprehensive market view?**

As this financial and economic crisis has powerfully demonstrated, regulators must work more closely together and with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We

need to ensure that our partners in regulating markets both here and around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors. Regulators must have a comprehensive market view in order to fulfill their mission. If confirmed by the Senate, I look forward to working with Congress to ensure we achieve these goals.

- **Does the current memorandum of understanding allow clearinghouses to choose their regulator based on which agency is least onerous, creating a “race to the bottom” effect?**

I believe we need to work with Congress and international regulators to ensure the highest standards of customer protection and market integrity by promoting consistent guidelines for transparency, accountability, and safety that are established and strictly enforced across all global commodities markets.

5. **Require FDIC insured banks to clear all swaps in energy and credit. A clearinghouse prevents systemic risk only if large banks use it. Even if the PWG succeeds in establishing a clearinghouse, large institutions will be able to execute uncleared trades at lower cost, exposing shareholders and the American people to counterparty default risk and our economy to systemic risk. Do you support legislation to require that FDIC guaranteed entities must clear all swaps contracts?**

I believe that all standardized over-the-counter derivatives, including interest rate, currency, equity, commodities and credit default swaps, should be brought into mandated centralized clearing. This would include those entered into by FDIC-guaranteed entities.

6. **Risk Based Swaps Oversight. The swaps loophole allows financial and energy bilateral over-the-counter contracts to be traded without government oversight of any kind. While bilateral swaps are private contracts of infinite variation, many have a substantive impact on the market. Acting CFTC Chairman Walter Lukken advocated using a risk-based approach to monitor selectively those swaps contracts traded in large volumes, used as a price reference, standardized, or expose the market to systemic risk. This approach was adopted in the Farm Bill provisions and in the Over-the-Counter Swaps Speculation Limit Act that I introduced in September. How do you propose to regulate bilateral swaps contracts to protect the market?**

I believe we must urgently move to enact a broad regulatory regime for the over-the-counter derivatives marketplace that best promotes transparency, accountability, and safety.

If confirmed by the Senate, I look forward to working with Congress to bring all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, establish a statutory and regulatory framework for derivatives dealers, formulate appropriate oversight for bilateral customized derivatives, and consider further additional regulation for credit default swaps.

Bringing all standardized over-the-counter derivatives into mandated centralized clearing could ensure the daily valuation of transactions through mark to market accounting, enhance the soundness of the system by requiring the timely posting of collateral, and increase transparency into dealers' total aggregate trading positions by underlying commodities.

Bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, enhance the price discovery function, and provide additional safeguards for investors.

I believe we must establish a statutory and regulatory framework for derivatives dealers including appropriate capital requirements, business conduct standards, and other rules.

I also believe we need to consider appropriate regulations for customized bilateral derivatives that will allow commercial interests and hedgers to maintain the benefits of these contracts, while assuring the transparency, accountability and safety of the system.

Credit default swaps have a close relationship to corporate bonds and other securities. Credit default swaps were used also by some banks to manage their bank capital requirements and to structure asset securitizations. Given these factors, I believe multi-agency regulatory cooperation will be necessary in working with Congress to design possible new regulations for these products.

7. **A Central, Real-Time Trading Database.** My attempts to require large trader reporting of bilateral swaps failed in 2002 and 2003. As a result, no centralized source of information about voice brokered swaps exists. According to Texas Law Professor Henry Hu, "a data clearinghouse may help provide advance notice to regulators of possible entity-specific or system-wide problems and early remediation. Should problems arise, this data clearinghouse can contribute materially to the informational predicate for proper regulatory responses to such problems."

In examples including Enron, Amaranth, and AIG, regulators failed to anticipate market failures of devastating proportion because they did not have a picture of the marketplace. A data clearinghouse would enable the regulator to anticipate problems and address them.

- **Do you support creating central database of all bilateral swaps positions in both financial and energy markets held by any large trader?**

As I have stated, I believe that all standardized over-the-counter derivatives, should be brought into mandated centralized clearing and onto exchanges. I also believe that we need to formulate appropriate oversight for bilateral customized derivatives. Registration of all derivatives clearing houses with the CFTC as DCOs, along with appropriate reporting requirements for customized bilateral swaps, could serve the goal of creating a central database of all bilateral derivatives positions in both the financial and energy markets.

- **In 2008, CFTC used its special call authority to solicit swaps positions held by institutional investors, but this dataset was incomplete. Will you use CFTC's existing special call authority to establish a central swaps database for large traders within 120 days of your confirmation?**

I believe that a broad regulatory regime is needed for over-the-counter derivatives. Moving all standardized over-the-counter derivatives into mandated centralized clearing and onto exchanges, formulating appropriate oversight of customized derivatives, and regulating derivatives dealers, should provide the means to establish and maintain such a central database for large traders. The CFTC also has a special call authority to solicit information from institutional investors. If confirmed by the Senate, I look forward to working swiftly with Congress to determine the best means of establishing a central swaps database for large traders.

- 8. Position Limits. OTC bilateral swaps speculators currently may hold unlimited positions, even if they do not have exposure to the underlying commodity or debt obligation. In energy commodities, unlimited speculation allows speculative positions to drive prices instead of supply and demand, and in credit default swaps traders even speculate on the third party's demise.**

- **Do you support imposing position limits on speculators in the energy swaps market and credit default swaps markets?**

Guarding against excessive speculation and market manipulation are two core functions of the CFTC's oversight responsibility. If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners to increase the CFTC's ability to guard against excessive speculation by increasing transparency around index and other non-commercial investors, reviewing all current hedge exemptions from position limits, and ensuring that position limits are applied consistently across all markets and trading platforms.

- **Do you support legislation that would limit speculative positions to ensure liquidity while preventing speculators from dominating the market?**

I believe that the CFTC may exercise its authority at its discretion to establish position limits over all commodity futures. If confirmed by the Senate, I will ensure that all available resources and authorities are deployed to protect investors in the commodities futures markets. If those authorities are insufficient, I will not hesitate to ask Congress for additional statutory authority to ensure liquidity and guard against excessive speculation.

- **Do you support imposing aggregate position limits on energy traders, so that position limits consider positions in functionally identical products, whether they are held in bilateral swaps, on electronic exchanges, on registered exchanges, or on foreign boards of trade?**

I believe the CFTC should examine ways to set aggregate speculative position limits on energy and agriculture futures across all contract markets. If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts.

- 9. Close the London loophole. Closing the London Loophole would prevent U.S. oil and financial derivatives from being traded on international exchanges without robust oversight. According to CFTC, U.S. oil futures traders on ICE Futures Europe exceeded U.S. speculation limits every single week from 2006 to 2008. In June, CFTC announced it would limit this offshore market speculation and require recordkeeping. But legislation is still needed to require foreign exchanges with U.S. customers to adopt the same speculation trading limits and reporting requirements that apply to United States trades – ending the regulatory race to the bottom. Will you endorse legislation to close the London loophole, which Senator Levin and I introduced in 2008?**

I support all actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations and reporting requirements that are applied to trades made on U.S. exchanges. Furthermore, I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits. If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

- 10. U.S. Leadership in an international reform effort. Electronic markets, fluid capital flows, and new financial centers in emerging markets make the balkanized financial regulatory system inadequate to meet new challenges. The United States could help restore our standing in the world by calling for and leading an effort to establish minimum international standards for market transparency, accountability, and oversight. How do you intend to pursue improved international cooperation?**

As this crisis has powerfully demonstrated, we must work more closely with our international partners on all of these issues. Today's complex financial markets are global, and as we have seen, absolutely and irreversibly interlinked. We need to ensure that our partners in regulating markets around the world apply the same rigor in enforcing standards of transparency, accountability and safety for investors that we will demand of our markets. If confirmed, I look forward to working with Congress and international regulators to ensure we achieve these goals.

- 11. Improve federal regulatory structure and coordination. American financial markets are overseen by seven regulators: the Federal Reserve System, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. In light of the**

conversion by Goldman Sachs and JPMorgan Chase into bank holding companies and recent acquisitions by other major financial institutions, the jurisdiction of regulatory authority has been blurred. A forward-looking, unified oversight structure should be developed to coordinate regulatory efforts and limit future gaps in oversight. What do you believe to be the benefits of maintaining CFTC independence, and what do you believe would be the benefits of combining the CFTC with other regulators?

If confirmed by the Senate, one of my principal goals will be to help reform our regulatory system, which has failed to keep Americans out of harm's way. I have a longstanding commitment to advocating for investor protection and for progressive reforms.

To revitalize our financial system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, borrowers, and investors.

I believe accomplishing these objectives must be the primary consideration in any proposed agency reforms. The CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important tasks with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake.

January 26, 2009

The Honorable Carl Levin
United States Senator
269 Russell Office Building
Washington, DC 20510

Dear Senator Levin,

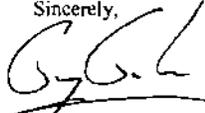
I am writing to respond to your series of questions regarding my nomination to be Chairman the Commodity Futures Trading Commission. Please find my responses attached.

I appreciated the opportunity to meet with you on January 14, 2009 to discuss the clear needs to strengthen the role of the CFTC. In addition I would like to thank you for your questions to further clarify my views on these important issues. I believe we are at a transformational time that requires bold leadership to strengthen our regulatory system.

As Chairman of the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs, I look forward to working with you should I be confirmed by the United States Senate.

Should you have further questions, please do not hesitate to contact me.

Sincerely,



Gary Gensler

**Questions for CFTC Chairman-Designee Gary Gensler
From Senator Carl Levin (D-MI)
January 26, 2009**

- 1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Can speculation in futures markets affect the actual cash price of a commodity?**

I believe that speculative trading or investing by persons who do not produce or use a commodity in order to profit from commodity price changes can affect prices for commodity futures as well as for the underlying commodities. I think we have seen this demonstrated in the commodity futures markets during the past several years.

If confirmed by the Senate, I look forward to working with Congress and my fellow CFTC Commissioners to take a fresh look at the role of speculation in commodity futures markets.

- 2. Section 4a of the Commodity Exchange Act states: "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. . . ." Section 4a directs the CFTC to establish position limits to prevent such burdens. Do you believe that excessive speculation in commodity futures traded on CFTC-regulated exchanges can cause "sudden or unreasonable fluctuations or unwarranted changes" in commodity prices?**

I believe that excessive speculation in commodity futures can cause sudden or unreasonable fluctuations or unwarranted changes in commodity prices. If confirmed by the Senate, I will ensure that the CFTC fulfills its statutory mission to guard against excessive speculation.

- 3. The CFTC has used the authority under section 4a to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. It has generally not used this authority to establish position limits to prevent levels of speculation that, absent proof of manipulation, may nonetheless significantly affect commodity prices. Do you believe that the CFTC should establish position limits to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing**

“sudden or unreasonable fluctuations or unwarranted changes” in the prices of commodities?

Guarding against excessive speculation and market manipulation are two core functions of the CFTC’s oversight responsibility. I believe that the CFTC may exercise its authority at its discretion to establish position limits over all physical commodities, including agricultural, metals and energy commodities. If confirmed by the Senate, I will ensure that all available resources and authorities are deployed to protect investors in the commodities markets.

For example, I believe there is a need to analyze all outstanding exemptions to position limits that have been granted previously to non-commercial hedgers (‘hedge exemptions’). If confirmed by the Senate, I will ask the CFTC staff to undertake a review of all outstanding hedge exemptions, to consider the appropriateness of those exemptions, and to evaluate potential practices for instituting regular review and increased reporting by exemption-holders

4. Do you believe that trading in commodity markets not regulated by the CFTC, such as over-the-counter (OTC) markets or foreign exchanges, can affect the prices of commodities in markets or exchanges regulated by the CFTC?

I believe that trading in over-the-counter derivatives markets or on foreign futures exchanges can and does affect the cash prices of commodities in the spot markets and the prices of commodity futures traded on regulated exchanges.

If confirmed by the Senate, I look forward to working with Congress and my fellow Commissioners in considering greater oversight and consistent regulation, where appropriate, for all markets relating to commodities.

5. Do you support amending the Commodity Exchange Act to provide the CFTC with sufficient authority to regulate commodity swaps and other instruments traded in OTC markets to ensure the integrity and transparency of the price of commodities traded in markets currently regulated by the CFTC?

I believe that both our financial system and our regulatory structure have failed the American people. To achieve the regulatory reform required by our citizens and the overall system, I believe we must work to ensure for a far more stable and resilient financial system, to better protect market integrity and the price discovery function, and to provide increased protection for consumers, borrowers, and investors. If confirmed by the Senate, I look forward to working with Congress, the Administration and other regulators to create a transparent, open and accountable regulatory oversight structure for the over-the-counter derivatives market.

I believe that we need to bring standardized products into mandated centralized clearinghouses and onto exchanges, establish a regulatory framework for derivatives dealers and formulate appropriate oversight for credit default swaps.

Bringing standardized derivatives products into mandated centralized clearinghouses would ensure the discipline of daily valuation of transactions through mark to market accounting. This measure would enhance the safety and soundness of the system by requiring timely posting of collateral. Clearinghouses also would give regulators a direct window into dealers' total aggregate trading positions by underlying commodities. Likewise, bringing standardized derivatives products onto exchanges would promote transparency, increase market integrity, and enhance the price discovery function.

If confirmed by the Senate, I look forward to working with Congress as well to consider appropriate regulations for customized bilateral over-the-counter derivatives.

One of the significant lessons of the financial crisis is that unregulated derivative dealers, many of which were affiliates of insurance companies or broker dealers, threatened and in some cases destroyed their parent or affiliate, causing global shockwaves. This was the case in AIG's failure, for example.

While serving at the Treasury Department as the Under Secretary for Domestic Finance in the late 1990's, I advocated for regulation of the then unregulated derivatives dealers affiliated with brokerage houses. I feel even more strongly that this is the right course of action today. If confirmed by the Senate, I look forward to working with Congress, my fellow Commissioners and other regulators to consider appropriate capital requirements, business conduct standards, and other rules for derivatives dealers.

Finally, if confirmed by the Senate, I look forward to working with Congress on considering possible further regulation of credit default swaps. Given the unique nature and close relationship of credit default swaps to corporate bonds and other securities, the CFTC, the SEC and other regulators, working in tandem, need to consider possible additional regulations to protect the integrity of the markets and investors.

6. Do you support providing the CFTC with authority to require the reporting of large trades in OTC markets in order to prevent manipulation, price distortion, or excessive speculation in CFTC-regulated futures markets?

As I stated in question 4, I believe trading and pricing in over-the-counter derivatives markets can and does have a direct effect on regulated futures markets. The initiatives I have set forth in question 5 would give the CFTC greater visibility into the over-the-counter derivatives markets if enacted. Furthermore, if confirmed by the Senate, I look forward to working with Congress to consider both the appropriateness and the potential means of extending position limits to certain of these markets.

7. The 2008 Farm Bill provided the CFTC with authority and directed the CFTC to promulgate rules to regulate commodity contracts traded on electronic trading facilities that the CFTC finds perform a significant price discovery function.

a) Do you believe that the trading of commodity contracts on electronic trading facilities like the Intercontinental Exchange (ICE) can affect the price of similar contracts traded on CFTC-regulate futures exchanges?

I believe that trading of “look-alike” contracts on electronic-trading facilities can and does affect the prices of similar contracts traded on regulated futures exchanges.

b) What priority would you place, if confirmed, on issuing the regulations called for in the Farm Bill for contracts that perform a significant price discovery function?

If confirmed, I would place a high priority on closing the “Enron Loophole” and promoting uniform standards for contracts that have the same practical pricing effects, as called for in the Farm Bill.

c) Do you agree that under the 2008 Farm Bill the CFTC has unilateral authority to determine which contracts perform a significant price discovery function and that a formal hearing or rulemaking is not required to make this determination?

The statute as enacted is clear that the CFTC has unilateral authority to determine whether an agreement, contract, or transaction performs a significant price discovery function.

8. What is your view on whether and how the growth of commodity index funds over the last 5 years has affected commodity prices?

I believe that rapid growth in commodity index funds was a contributing factor to a bubble in commodities prices that peaked in mid-2008. The expanding number of hedge funds and other investors who were increasing asset allocations to commodities within their portfolios also put upward pressure on prices. Notably, though, no reliable data about the size or effect of these two influential investor groups has been readily accessible to market participants.

If confirmed by the Senate, I look forward to working with my fellow Commissioners and the Congress to increase transparency around these commodity index funds and investors. The CFTC currently provides weekly “Commitments of Traders” reports (COT’s), which show large position interests in certain commodities subject to CFTC oversight. These published reports are segmented into “commercial” and “non-commercial” positions and in some cases, nearly 90% of reported open interests are held by non-commercial traders. I believe we could promote greater transparency and market integrity by providing a further breakdown of non-commercial open interests.

9. If confirmed, would you seek to improve the CFTC's data and public reporting of data to improve the understanding of how commodity index funds affect commodity markets? What improvements in data would you like to see?

As I have stated above in my answer to question 8, if confirmed by the Senate, I plan to reevaluate the CFTC's data collection and production capacity, particularly as it relates to the effect of commodity index funds and non-commercial traders on the broader commodities markets. The CFTC is likely to require further resources and additional technology to accomplish this goal.

10. If confirmed, how would you strengthen and improve the CFTC's market surveillance and oversight?

Providing market surveillance and oversight is one of the CFTC's core functions. As outlined in questions 5 and 6, if confirmed by the Senate, I look forward to working with Congress to address the regulation of over-the-counter derivatives and excessive speculation in commodities markets. I believe the CFTC will require increased resources to carry out these new initiatives, which will promote market integrity and increase transparency, thereby improving the surveillance and oversight functions. If confirmed by the Senate, I look forward to working with the Congress to secure the much-needed additional resources to undertake these reforms and strengthen this area.

11. What is your view of the CFTC's enforcement capabilities? How would you strengthen and improve the CFTC's enforcement capabilities and activities?

A highly functioning enforcement capability is critical to an effective CFTC. The CFTC's enforcement division has brought some notable recent actions with limited current resources. If confirmed by the Senate, I will request more attorneys and investigators to detect and prosecute fraud and manipulation in these markets and to enforce possible new regulations regarding over-the-counter derivatives and excessive speculation in the commodities markets.

12. Do you agree that the CFTC's budgetary and staff resources have not kept pace with the growth in commodity markets over the past decade? Do you agree that the CFTC is currently underfunded? If confirmed, how would you seek to improve the CFTC's budgetary and staff resources?

The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. I am also concerned that the CFTC lacks the necessary technology to monitor today's markets effectively.

If Congress acts to expand the CFTC's mission and authority to better regulate over-the-counter derivatives markets, address excessive speculation, and increase investor protection, significant additional resources will be required.

- 13. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I believe the critical issue is to find adequate resources to support the important work that lies ahead for this Commission. The CFTC is significantly underfunded to simply meet its current mandates. While I have not made an independent determination about user funding, I intend to work with Congress and the Office of Management and Budget to find the most effective ways to secure the resources necessary for the CFTC to function fully.

- 14. Currently, the CFTC permits certain foreign exchanges, such as ICE Futures and the Dubai Mercantile Exchange, to install trading terminals in the United States so as to permit traders located in the United States to trade various U.S. energy commodities on these foreign exchanges as well as on U.S. exchanges. In 2008, the CFTC determined that in order for ICE Futures to continue to operate its trading terminals in the United States it would require ICE Futures to impose comparable position limits to those of the NYMEX for commodities traded on both exchanges. ICE Futures and the U.K. Financial Services Authority have agreed to these conditions.**

- a) Do you support the CFTC's actions in 2008 to ensure that foreign exchanges that are operating in the United States impose position limits that are comparable to those of the U.S. exchanges that trade the same commodities?**

I support the CFTC's 2008 actions to close the "London Loophole" and ensure that foreign futures exchanges with permanent trading terminals in the U.S. comply with the position limitations applied to U.S. exchanges.

- b) If confirmed, would you impose similar conditions on the Dubai Mercantile Exchange and its regulatory authority, if it has not already agreed to them?**

I believe any foreign futures exchanges that have terminals in the United States to which our investors have access and whose contracts are based on the same underlying commodities should have consistent regulation applied, including position limits.

- c) Would you support legislation to codify the CFTC's authority to require such comparable position limits and reporting requirements in order to ensure that all foreign exchanges that seek to operate in the United States and trade U.S. commodities are subject to comparable requirements?**

If confirmed by the Senate, I look forward to working with Congress on legislation to codify the CFTC's authority to promulgate regulations regarding look-alike contracts trading on foreign futures exchanges that affect U.S. investors.

- d) Do you believe the CFTC currently has enforcement authority over traders in the United States who are trading on a foreign exchange through foreign terminals located in the United States if those trades affect the prices of commodities in the United States?**

I believe that the CFTC has enforcement authority over traders in the U.S. who are trading on a foreign exchange through foreign terminals located in the U.S. when and if those trades affect the prices of U.S. commodities. If confirmed by the Senate, I would work aggressively with the CFTC's legal staff to ensure that U.S. interests are protected, and I would not hesitate to come back to Congress and ask for further enforcement authorization if necessary.

- 15. It has been reported in the press that during the Clinton Administration you supported efforts to restrict the CFTC's jurisdiction over various types of swaps and other derivatives. In 2000, Congress enacted the Commodity Futures Modernization Act (CFMA) which restricted both the CFTC's and SEC's authority to regulate commodity and financial derivatives.**

- a) What were your job titles and positions from 1998-2000?**

I was Assistant Secretary of Financial Markets at the Treasury Department from September of 1997 through April 1999; thereafter through the end of the administration I was Under Secretary for Domestic Finance.

- b) Please describe your role, if any, in the efforts by the SEC, Department of Treasury, and Federal Reserve to oppose the CFTC's potential assertion of regulatory authority over swaps and derivatives in 1998.**

I was not involved in these matters, which occurred primarily during the spring and summer of 1998. This was during my first year at the Treasury Department and I had been advised by Treasury Department Counsel that I was recused from these particular matters since they might relate directly to my former employer.

- c) Please describe your role during the negotiations over the CFMA, including over provisions in the CFMA to limit SEC and CFTC authority to regulate swaps, including interest rate, currency, equity, credit default, and commodity swaps. Please also include any role you played during the negotiation to limit state authority to regulate these swaps.**

The drafting and passing of the CFMA legislation was a lengthy and complex process, involving at least four government agencies including the Federal Reserve, the SEC, the CFTC and the Treasury Department, as well as hearings in front of at least five Congressional Committees. As I was no longer subject to the restrictions of recusal in

2000, I was a member of a team that worked with and advised then-Treasury Secretary Lawrence Summers on Treasury's positions. I do not recall participating in any negotiations over state regulatory authority.

16. In 1998, former SEC Chairman Arthur Levitt, Treasury Secretary Lawrence Summers, and Federal Reserve Chairman Alan Greenspan all opposed the CFTC's attempts to examine the OTC swaps market, and then supported the 2000 statutory restrictions on the SEC's and CFTC's authority over swaps in the CFMA. Former Chairman Levitt recently stated that he now regrets the position he took during those years: "The market was too large, too explosive in growth to merely allow pure market forces to suffice as self-regulatory mechanisms. I have some regrets about it, clearly." In October 2008, Mr. Levitt wrote: "Our nation's financial markets are in the midst of their darkest hour in 76 years. We are in this situation because of an adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions. Our regulatory system failed to adapt to important, dynamic and potentially lethal new financial instruments as the storm clouds gathered."

- a) Do you agree with former Chairman Levitt's statement that our regulatory system has failed to adapt to the development of new financial instruments and that the positions taken in 1998-2000 to deregulate these markets was, in retrospect, a mistake? If so, how would you correct this deficiency?
- b) Would you support repealing the statutory prohibitions in the CFMA on federal regulation of swaps? If so, should these swaps be regulated as commodities or securities?

Response to a) and b):

I believe that both our financial system and our regulatory structure failed the American people. There were many elements that contributed to these failures. Certainly one of these was regulators' inability to adapt to new financial instruments and technologies.

It is important now to move swiftly and intelligently to repair the system. If confirmed by the Senate, I look forward to bringing my experience in the Executive Branch, in the Legislative Branch as a senior advisor to Senator Sarbanes, in the private sector, and as an investor advocate, to help bring about far-reaching regulatory reform.

While I believe markets are central to innovation and growth, I have always advocated for sensible regulation. Well-designed financial rules with strong enforcement mechanisms are critical to protecting homeowners, investors, farmers and the integrity of our markets and economy. I believe we must create a more stable and resilient financial system, ensure market integrity by promoting transparency and accountability, and increase protection for consumers, borrowers, and investors.

As outlined in questions 5 and 6, if confirmed by the Senate, I look forward to working with Congress to address the regulation of over-the-counter derivatives and excessive

speculation in commodities markets. With respect to over-the-counter derivatives, I look forward to working to bring standardized products into mandatory centralized clearinghouses and onto exchanges, establish a regulatory framework for derivatives dealers, and consider possible further regulation for credit default swaps.

17. Former Federal Reserve Chairman Alan Greenspan testified in October that he, too, now believes that the conceptual framework underlying the deregulation of swaps in the CFMA was a mistake. Mr. Greenspan testified: "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms. . . . So the problem here is something which looked to be a very solid edifice and, indeed, a critical pillar to market competition and free markets did break down."

- a) **Do you agree with Mr. Greenspan's recent statements that the financial collapse of 2008 has demonstrated the errors in the assumptions underlying the deregulatory approach in the CFMA? Can we rely on commodity market participants and unfettered free market forces to prevent systemic risks and unreasonable price fluctuations in U.S. commodity markets?**
- b) **Do you support stronger regulation of U.S. commodity markets to protect market participants and prevent systemic risks and unreasonable price fluctuations, and, if so, how?**

Response to a) and b):

I believe that the American public and our economy benefit from a regulated market system. The recent crisis revealed that market participants have failed at their own risk management and in their obligation to protect their customers, their investors' money, their shareholders and even their franchises in many cases.

Our regulatory system also failed to protect investors, savers, borrowers, farmers and homeowners. As I mentioned in my previous answer, I believe that we must have additional safeguards in place to protect markets and investors against the risks we have witnessed in the past year. If confirmed by the Senate, I look forward to working with Congress and the Administration to meet the responsibilities that lie before us. To reform the financial system, we must establish a regulatory framework that ensures a strong and stable financial infrastructure, promotes market integrity and the price discovery function, and provides increased protection for consumers, borrowers, and investors.

As I have stated in my previous answers, I support stronger regulation of U.S. commodity markets. If confirmed by the Senate, I look forward to working to bring over-the-counter derivatives into mandatory central clearinghouses and onto exchanges, establish a regulatory structure for derivatives dealers, and consider possible additional regulation for credit default swaps.

18. What is your view of the proposal to merge the SEC and the CFTC? Would you support or oppose such a merger, prefer to retain the CFTC as a separate independent agency, or prefer some other approach?

If confirmed by the Senate, my principal goal will be to help reform our regulatory system, which failed to keep so many Americans out of harm's way. I have a longstanding commitment to advocating for investor protection and for progressive reforms. To revitalize our financial system, I believe we must tackle a robust agenda including modifying regulation of mortgage origination and securitization, credit rating agencies, hedge funds, over-the-counter derivatives markets, and capital rules and counterparty risk standards. Additionally, we must improve systemic regulation, increase transparency, and put new protections in place for consumers, borrowers, and investors.

I believe accomplishing these objectives must be the primary consideration in any proposed regulatory reforms. The CFTC performs vital functions and it is critical that all of its mandates are preserved, even as the demands on our regulatory agencies expand. A merger makes sense only if it enhances our ability to carry out the important tasks with which the CFTC is entrusted. Thus, I would not consider a merger simply for merger's sake.

19. In 2004, Congress enacted legislation imposing a one-year cooling-off period before federal bank examiners could take a job with a bank they oversaw. If confirmed, would you support a similar cooling-off period for commodity regulators?

If confirmed by the Senate, I would support a similar cooling-off period for commodity regulators.

○

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2010

TUESDAY, JUNE 2, 2009

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:33 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Tester, and Collins.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing on the fiscal year 2010 funding request for two key Federal regulatory agencies within the jurisdiction of this Appropriations Subcommittee on Financial Services and General Government, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

I also want to welcome my friend and my distinguished Ranking Member Senator Susan Collins. We have worked together in many venues, and I'm glad that we're going to share the responsibilities of this subcommittee.

Joining us today to present testimony on the two budgetary proposals are the Honorable Mary Schapiro, Chairman of the SEC, and the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission.

Both of these agencies enjoy unique histories, hold specialized and independent responsibilities and take different approaches to markets that serve different purposes, yet the CFTC and SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity.

We are enduring an extraordinary set of circumstances in our Nation today. We are beginning to slowly emerge from one of the greatest economic crises in decades. After years of struggle, countless families have lost their hard-earned savings, seen their dreams deferred and even denied.

Some may view the subject matter of this hearing as dry as dust, how much money to give to two Federal agencies, but if you step back for a moment and translate their work into the real world, re-

alize that their oversight and their regulation literally protects the savings and futures of American families and ensures that economies in countries around the world will view our economy and the way we run it with respect to as to whether or not the rule of law is going to be followed.

The unprecedented price volatility of our markets for fiscal commodities, such as energy and grains, has hurt our economy, in addition to the previous mention I made of some of the problems that we've had with savings and the like.

Now perhaps more than ever, we need our markets to function transparently and be insulated from manipulation and unfettered excessive speculation. Much remains to be done to stabilize and sustain our financial system.

Chairman Schapiro and Chairman Gensler each bring vast experience to their new leadership posts in this administration and have undoubtedly identified in their brief tenure ways to improve the way we approach regulating securities and futures markets.

As the subcommittee prepares to make difficult funding decisions, I look forward to hearing about the challenges their agencies will face.

In the interest of time, I am going to ask that the remainder of my statement be made a part of the record so that we will have opportunity for testimony and for questions.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

The CFTC and the SEC enjoy unique histories, hold specialized and independent responsibilities, and take different approaches to markets that serve differing purposes. Yet the CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in our country.

Market users, financial investors, and the U.S. economy rely upon vigilant oversight by these two agencies in today's evolving—and often volatile—global marketplace.

We are enduring an extraordinary set of circumstances in America today. We are beginning to slowly emerge from one of the greatest economic crises since the Great Depression. After years of sweat and struggle, countless families have lost their hard-earned savings, seeing their dreams daunted, deferred, and even denied.

When a man named Bernard Madoff can, over the span of 10 or 20 years, lure investors into what has turned out to be a Ponzi scheme, causing many of them to lose millions of dollars, and his wrongdoing goes unnoticed by major regulatory agencies, it is clear more has to be done.

When some of the major ratings agencies that gauge whether a company is doing well basically ignore their responsibility and fail to make accurate reports, everyone loses as a result of it.

The unprecedented price volatility of our markets for physical commodities, such as energy and grains, has hurt our economy. Now—perhaps more than ever—we need our markets to function transparently and insulated from manipulation and unfettered excessive speculation.

The Obama administration recently announced a comprehensive plan to significantly regulate credit default swaps and other over-the-counter derivatives. Exempting these investments from regulation has proven to be a costly mistake—contributing to the \$180 billion taxpayer bailout of AIG, the collapse of Lehman Brothers, and the demise of Bear Stearns.

This proposal will require far more transparency and responsibility from derivatives traders that have long operated in the shadows.

Things are still very fragile. Much remains to be done to stabilize, repair, and sustain our financial system on which we all depend. It will take time to redeem the lost faith of the American people in the government institutions they expected would protect them. But I believe we are moving forward with resolve toward a brighter economic course.

I appreciate the fact that Chairmen Schapiro and Gensler have each accepted President Obama's call to be part of the economic leadership team to help craft a more reliable regulatory framework and guide us to a better future.

Both Chairmen bring vast experience to their new leadership posts in this administration—and have undoubtedly identified, even in their brief tenures, ways to improve the way we approach regulating in the securities and futures markets.

As the subcommittee prepares to make difficult funding decisions for the next fiscal year, I look forward to hearing about the particular challenges their respective agencies face in today's tumultuous economic environment. I welcome their input on how we can best help to address those needs.

Before hearing from our panelists, I'd like briefly outline the missions of these agencies and their budget proposals:

Turning first to the SEC, its three-prong mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC is the investor's advocate.

The SEC is responsible for overseeing more than 12,000 publicly traded companies, over 11,300 investment, nearly 8,000 mutual funds with \$9 trillion in assets, fund complexes, 5,500 broker dealers with over 174,000 branches, 10 credit rating agencies, and close to \$44 trillion worth of trading conducted each year on America's stock and option exchanges.

The strength of the American economy and our financial markets depends on investors' confidence in the financial disclosures and statements released by publicly traded companies. Investors expect the SEC to be the vigilant "cop on the beat." Regrettably, in many respects, we let them down. I have faith in Chairman Schapiro's leadership and tenacity to turn things around.

This subcommittee wants to make certain that the SEC has the necessary resources to effectively fulfill its obligatory singular mission: protecting shareholders.

The SEC's budget request for fiscal year 2010 totals \$1.026 billion, an increase of \$8.8 million, or 8.8 percent over the agency's fiscal year 2009 enacted level of \$943 million. This proposed fiscal year 2010 budget would fund 3,692 FTE, just 40 more than the current year funding permits.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions for violations of the securities laws, such as insider trading, accounting fraud, and providing false or misleading information.

Serious, thoughtful questions have been raised about whether the proposed enforcement budget is adequate to keep pace with the growing demands.

Second, the CFTC: The CFTC is charged with protecting the public and market users from manipulation, fraud, and abusive practices. It is also responsible for promoting open, competitive, and financially sound markets for commodity futures.

The CFTC helps ensure that the futures markets are equipped to better perform their vital function in the U.S. economy—providing a mechanism for price discovery and a means of offsetting price risks.

The CFTC's oversight and enforcement mission becomes tangible when you consider that futures prices impact what we pay for the basic necessities of our daily lives: our food, clothing, shelter, fuel in our vehicles, and heat in our homes.

This year—2009—marks the 35th year since the establishment of the Commodity Futures Trading Commission. At the time of its inception in 1974, CFTC's 500 employees were tasked with the mission of ensuring fair practices and honest dealings on the commodity exchanges of America's then-\$500 billion futures industry.

Today it is a \$22 trillion industry that looks vastly different. Yes, the traditional agricultural products like wheat, corn, soybeans, and the proverbial pork bellies are still part of the picture. But the landscape has been remarkably altered and diversified with novel and complex commodities . . . everything from grains to gold, currencies to carbon credits.

In the past decade, trading volume has increased more than ten-fold—reaching well over 3.4 billion trades in 2008, and actively traded contracts have quintupled—from 286 in 1998 to 1,521 in 2008. CFTC oversees \$5 trillion of trades—daily.

Adding to this challenge is a significantly transformed globalized, electronic, and round-the-clock marketplace. Moreover, the emergence of derivatives and hedge funds have altered the regulatory environment.

Layered on this are new authorities added through the 2008 farm bill, coupled with escalating public angst about record energy and agricultural commodity price hikes and fluctuations, and a growing influx of financial funds into the futures markets.

Further complicating the picture are transactions that the CFTC currently has no power to presently regulate—the vast "shadow" world of over-the-counter derivatives—like credit default swaps.

Surprisingly, what hasn't changed is the number of staff. Despite the phenomenal surge in volume and activity, CFTC staffing levels have simply not kept pace. In fact, staffing levels have dropped by over 20 percent. CFTC's workforce—like its predecessor over three decades ago in the agency's fledgling years—presently numbers only 500.

For fiscal year 2010, the President's budget request funding for the CFTC of \$160.6 million. This represents an increase of \$14.6 million—a 10 percent hike—above the fiscal year 2009 enacted level of \$146 million.

Of the \$14.6 million in increased funding for next year, \$7.4 million is slated for increased compensation and benefit costs for a staff of 572; \$0.2 million will be devoted to increased operating costs for information technology modernization, lease of office space, and other services; and \$7.8 million will support the salary and expenses of 38 additional full-time staff.

Last August, I had the opportunity to visit the CFTC's Chicago Regional Office. I met with a group of dedicated staff committed to doing outstanding work under challenging circumstances. I learned first-hand just how thin the staffing is.

The CFTC's Chicago market surveillance staff consisted of 10 economists who conduct daily oversight of each actively traded market and 6 trading specialists who process the daily reports detailing traders' actual positions in each market.

These economists are responsible for surveillance of over 1,250 different commodity futures and option contracts, of which 325 are active, involving 13 different commodity types. The commodities underlying the futures contracts the staff must monitor are highly diverse—including grains, livestock, lumber, currencies, Treasury instruments, equity indexes, single stock future, and dairy. More recently, weather derivatives, real estate indexes, and environmental products such as carbon credits and emission allowances became part of their portfolio.

A single staff economist must cover many markets. For example, one staffer is responsible for 10 grains, one for 90 currencies, and one for the surveillance of over 500 hundred single stock futures. Aside from supervision by the chief of the Chicago surveillance section and Washington, DC supervisory personnel, there is limited redundancy built into the system. As a consequence, each one of those economists is critical.

The six trading specialists maintain an extensive daily data-gathering and verification system by collecting reports from exchanges, futures industry firms, and traders. As our energy debate in Washington throughout the last Congress demonstrated, this data collection is very important to the Commission's oversight and to market transparency.

As I pledged since assuming the Chairmanship of this committee, I am serious about addressing the resource deficiency facing this agency.

I will appreciate hearing from both Chairmen their honest appraisals about the resources they will require to achieve their missions, keep pace with change, and become as sophisticated as, if not more so, than the entities they monitor—while responsibly managing taxpayer dollars.

Senator DURBIN. And I now turn it over to my Ranking Republican Member, Senator Collins.

STATEMENT OF SENATOR SUSAN COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Let me begin by saluting you for your leadership on this subcommittee. I am just delighted to be your new ranking member.

About two decades ago, I spent 5 years in Maine State government as a financial regulator overseeing the bureau of banking, insurance, securities administration, and I have a great personal interest in this area because I know that the decisions made by the SEC and the CFTC do, as you have pointed out, have such an impact not only on our economy but on the daily lives of most American families.

So it's a great honor to serve with you as your ranking member and I very much look forward to working cooperatively with you throughout this Congress.

As we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, let me also salute the chairman for his

leadership in securing significant increases for both of these agencies.

Thanks to the work of this subcommittee and the chairman's leadership, the budget for the SEC is now nearly 9 percent above the fiscal year 2007 funding level and the budget for the CFTC is 49 percent above that year.

These increases are extremely important, given that both of these agencies were woefully underfunded for years. I personally believe that they're still underfunded and that more work needs to be done.

I want to congratulate the two chairmen for appearing before our subcommittee today with aggressive agendas for change and reform. I look forward to hearing the details about the budget requests.

As the chairman has indicated, the current economic crisis has left our markets in turmoil and the loss of trillions of dollars of value in these markets has depleted family savings, shuttered small businesses and damaged retirement and pension funds.

I am convinced that we not only need to make sure these two agencies have the resources necessary but that we need to proceed with regulatory reform, as well, in order to restore confidence in our markets and to prevent the root causes of the current financial crisis from springing up once again.

Mr. Chairman, I am going to follow your lead and submit the remainder of my statement, as well, but I am delighted to be joining you to work on these critical issues.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SUSAN COLLINS

Good morning. At this first hearing of our subcommittee, I want to thank you, Chairman Dnrbin, for your leadership. This Subcommittee has jurisdiction over a diverse group of agencies, many of which have a profound impact on the financial stability of our economy and on the lives of most Americans. So it is an honor to serve with you as Ranking Member of this subcommittee, and I look forward to working cooperatively with you during this Congress.

Mr. Chairman, as we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, I want to salute you for your leadership in securing significant increases for both these agencies during your chairmanship of this subcommittee. Thanks to your hard-fought efforts, the budget for the SEC is now 8.9 percent above the fiscal year 2007 funding level, and the budget for the CFTC is 49 percent above the fiscal year 2007 level. These increases were extremely important, given that both of these agencies had been woefully underfunded over the years.

Chairman Schapiro and Chairman Gensler: Congratulations and thank you both for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2010 budget requests and the key efforts that you plan to undertake this year. You both have crucial roles in our economy: SEC, by protecting the public through enforcement of securities laws, and CFTC, by protecting market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options.

Protecting investors is more compelling than ever since many first-time investors have turned to the markets to help secure their retirements, pay for homes, and send their children to college.

Our current economic crisis has left our markets in turmoil. The loss of trillions of dollars in value in these markets has depleted family savings, shuttered small businesses, and damaged retirement and pensions funds.

Chairman Schapiro, I am troubled by reports that an environment of lax oversight and enforcement at the SEC was a contributing factor to the current financial crisis. For example, some investment banks were allowed to become over-extended, which

led to the collapse of several of Wall Street's largest banks. The Bernard Madoff ponzi scheme went undetected for decades, resulting in \$50 billion in investor losses. So Madam Chairman, I am pleased that you have developed an ambitious agenda of management reforms for the Commission, and I am interested in hearing what resources you need to accomplish these reforms.

Chairman Schapiro and Chairman Gensler: You both have challenging tasks in front of you. You must improve transparency in our securities markets and uncover fraud and deception, while not over-regulating our markets and hindering our economic recovery. I look forward to working with both of you, and with Chairman Durbin to ensure that you have the resources and the tools you need to ensure investors are protected and that markets are functioning properly.

I look forward to your testimony and I thank you for your service to our Country. Thank you, Mr. Chairman.

Senator DURBIN. Thanks a lot, Senator Collins.

Senator Tester, would you like to make an opening statement?

Senator TESTER. Thank you, Mr. Chairman.

Just to welcome Mary and Gary to the subcommittee today. I appreciate the work that you have done and I appreciate the work you are about to do. I think it's critically important that we have good, solid, reasonable enforcement and I think both of you are up to that challenge.

So with that, we'll move on. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Tester.

Chairman Schapiro, the floor is yours.

Ms. SCHAPIRO. Chairman Durbin, Ranking Member Collins, and Senator Tester, thank you very much for the opportunity to testify today.

In the short time that I've been at the SEC, we have taken on an active agenda, all with the goal of protecting investors, revitalizing the agency, and restoring confidence in the markets. We are making great strides, yet recognize that we have quite a distance to go.

In the area of enforcement, we have changed our policies so that our investigators do not have to jump over unnecessary hurdles before seeking penalties or launching investigations. We have hired a former Federal prosecutor to lead the Enforcement Division, someone who is focused on bringing significant cases with a meaningful impact as quickly as possible and ensuring that the Division is appropriately organized to do just that.

We have begun to update our management systems, to upgrade our risk assessment capabilities so that we can better detect fraud, and we have expanded and improved upon our training so that our staff will be able to keep pace with the new financial products and strategies created on Wall Street.

Already we are seeing results. Since the end of January, as compared with the same period last year, we have filed nearly three times as many temporary restraining order cases, issued more than twice as many formal orders and opened over 20 percent more investigations into fraud.

Although enforcement is central, it is still just one part of our agency. As you know, we are tasked with overseeing broker-dealers, investment advisors, and mutual funds, and we are taking steps to improve our ability to do just that.

For instance, we are working on a risk-based initiative to improve our oversight methods so that we can better identify and focus resources on riskier institutions. We also are recruiting senior

professionals with new skill sets, such as trading, risk assessment and financial analysis, and we have created an Industry and Risk Management Fellows Program to bring top talent into the agency.

SEC'S RULEMAKING AGENDA

In addition to internal management directives, we also have engaged in an active rulemaking agenda. Last month, the SEC proposed significant changes to the rules governing investment advisors who maintain custody of their clients' assets.

Should the proposals be adopted, advisors with custody will have to undergo a surprise exam by an independent public accountant once a year to verify client assets and any custodian affiliated with an advisor would also be subject to custody controls reviews by an independent accountant. The goal is to expose Ponzi schemes and other frauds earlier.

In the area of short selling, the Commission unanimously voted to propose two distinct approaches to limit short selling. One would impose a permanent market-wide short sell price test, the other approach would impose temporary short selling restrictions upon individual securities during periods of severe price declines.

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. We will focus on tightening credit quality, maturity and liquidity standards for money market funds.

We're also exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value to better prevent abuses and avoid runs on the funds.

Additionally, I have asked the staff to undertake a comprehensive review of rule 12(b)(1) which allows mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses.

In the area of proxy access, the Commission already has proposed rules that would enhance the ability of shareholders to nominate company directors and next month we will take up a broad packet of corporate disclosure improvements around compensation policies, the use of compensation consultants, and the interplay between risk-taking and incentive arrangements.

But there is still more to do in the regulatory arena. We have been working closely with other Federal agencies to bring the unregulated world of credit default swaps into the sunlight.

Operating under the limitations of the current legislative structure, we recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps.

In the coming months, we will also tackle issues related to municipal market reform, stock lending, trading in non-transparent markets or dark pools, and hedge fund oversight. I look forward to working with Congress on these issues.

RESOURCES NEEDED FOR SEC'S MISSION

The financial crisis has reminded us all just how large, complex and critical to our economy the securities markets have become. At the SEC, our 3,700-person staff now oversees more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual

funds, 11,000 advisors, and 5,000 broker-dealers, and it is a number that is growing rapidly.

Nonetheless, during this same period the SEC's resources have fallen. Between 2005 and 2007, the agency saw 3 years of flat or declining budgets and lost 10 percent of its employees. This has an impact.

With support from this subcommittee during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce, and I am very grateful for that support.

But even with these important steps, the number of staff remains below the levels of only a few years ago. I believe additional resources are essential to restoring the SEC as a vigorous and effective regulator.

The President has requested a total of just over \$1 billion for the agency in fiscal year 2010, a 7 percent increase over this year's level. This budget request would permit us to fully fund an additional 50 staff positions over 2008 levels. These positions would help the SEC's Enforcement Program enhance its pursuit of tips and complaints and fully fund our new Fellows Program that brings in seasoned industry professionals.

In addition to expanding our workforce, the President's request also would enable us to invest more in new technology, a budget item that has dropped by more than one-half in the last 4 years.

Mr. Chairman, I came to the SEC to shape public policy in the interest of investors and to strengthen our Enforcement Program. The measures I have described today are important to those efforts, but what I have also discovered is that we cannot neglect the internal operations of the agency, the processes that guide our work and the agency's infrastructure.

I am committed to a complete review of the internal operations to ensure that we meet the highest standards and that we are fully supporting the important work of our employees. To ensure that we do it right, I intend to bring in a chief operating officer to manage that process.

I want to thank you for your continued strong support of the SEC and its critical mission. I believe that by strengthening our Enforcement Program, enhancing risk-based oversight, and leveraging technology, we can restore investors' confidence in both the SEC and in our Nation's securities markets.

PREPARED STATEMENT

I look forward to answering your questions. Thank you.
 Senator DURBIN. Thanks, Chairman Schapiro.
 [The statement follows:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

Chairman Durbin, Ranking Member Collins, Members of the Subcommittee, thank you for the opportunity to testify today. I sincerely appreciate the support this Subcommittee has shown the Securities and Exchange Commission, and I am pleased to have the opportunity to discuss with you the Commission's role in helping to address the financial crisis, and to discuss reforms to improve investor protection and restore confidence in our markets.

The last year has been a wrenching time for the investors whom the SEC is charged with protecting. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink dramatically as a result. The economic crisis

has challenged faith in our system of capital formation and allocation—a system that has proved over the long term to be the greatest for creating wealth the world has seen.

As an agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, we are dedicated to understanding and learning from recent events and from the causes that were building in the system over the years, so that we can do our part to restore market integrity and investor confidence. The SEC must act promptly, decisively, and with resolve. We also must have a renewed commitment to protecting investors; they provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is the foundation upon which all our responsibilities are built.

To that end, I've already announced several changes at the agency that will reinforce our focus on investor protection and market integrity and redirect our energies toward restoring investor confidence.

REINVIGORATING SEC ENFORCEMENT

One of my very first actions as Chairman was to end the 2-year "penalty pilot" program, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases where the staff sought fines against public companies that violated the law. Some enforcement staff had complained that the procedures unnecessarily delayed the prosecution of cases, and discouraged the staff from either seeking a penalty or seeking an appropriately high penalty. At a time when the SEC needs to send a clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff, the penalty pilot program was an unnecessary hurdle to more active enforcement.

Another change I implemented to bolster the SEC's Enforcement program was to provide for more rapid approval of formal orders of investigation, which allow SEC staff to use the power of subpoenas to compel witness testimony and the production of documents. In investigations that require the use of subpoena power, time is of the essence; delay can be costly to an investigation. To ensure that subpoena power is available to the staff when needed, the agency has returned to a policy of timely consideration of formal orders by the serial process or, where appropriate, by a single Commissioner acting as duty officer.

In addition, I have hired a new enforcement director, a longtime Federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force, charged with focusing our enforcement efforts on bringing meaningful, high impact cases quickly. We are working together on management reforms—including harnessing technology, improving risk assessment, and improving training and supervision for our line law enforcement personnel—so that we can maximize our resources to combat fraud and wrongdoing in our markets. Our Division of Enforcement has been working diligently. Since the end of January,

—We have filed at least 34 emergency temporary restraining orders. During roughly the same period last year, we filed 12.

—We have opened more than 358 investigations. During roughly the same period last year, we opened 292.

—The Commission has issued at least 188 formal orders. During roughly the same period last year, the Commission issued 74.

Since January, we have brought a number of important and complex cases. For example, in the Reserve Fund matter filed in May, we charged certain operators of the Reserve Primary Fund, a \$62 billion money market fund whose net asset value fell below \$1.00 or "broke the buck" last fall, with fraud for failing to provide key material facts to investors and trustees about the Fund's vulnerability as Lehman Brothers Holding, Inc., sought bankruptcy protection. As part of this action, we are seeking to bring about an expedited, efficient, and equitable pro-rata distribution to shareholders of the Fund's remaining assets, including \$3.5 billion originally set aside in the Fund's litigation reserve.¹ We believe this will help Reserve Fund investors recover a larger share of their assets.

In March, we initiated a case alleging fraud in connection with a kickback scheme involving New York's largest pension fund. Namely, we charged New York's former Deputy Comptroller and a top political advisor with extracting kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since March, we have amended the complaint to add additional defendants, including a former New York State political party leader, a

¹ *SEC v. Reserve Management Company, Inc., et al.*, Lit. Rel. No. 21025 (May 5, 2009).

former hedge fund manager, a Dallas-based investment management firm and one of its founding principals, and a Los Angeles-based "finder."²

As committed as we are to vigorous enforcement of the securities laws, we are also mindful that the complexity of 21st century markets, as well as the varied nature of frauds and scams, require that the sophistication and tools available to our Enforcement and Examination programs keep pace. Important questions have been raised concerning the agency's handling of tips or whistleblower information related in particular to the activities of Bernard Madoff. Clearly this is something we must learn from, and I am committed to addressing it. Former Chairman Cox asked the SEC Inspector General to look into what happened, what failed to happen, and to report back to the Commission. We expect to receive the IG report this summer and will promptly take all appropriate actions and address any remaining shortcomings.

It is clear that, regardless of any findings of the Inspector General, the agency must improve its ability to process and pursue appropriately the hundreds of thousands of tips and referrals it receives annually. In February, we retained the Center for Enterprise Modernization which began work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. We are in the process of creating a system that will centralize this information so we can track it, analyze it and more effectively identify valuable leads for potential enforcement action and compliance exams.

STRENGTHENING EXAMINATION AND OVERSIGHT

In addition to these changes, it is essential that we work to improve our risk-based oversight of broker-dealers, investment advisers and mutual funds. Our Office of Compliance Inspections and Examinations (OCIE), together with other agency staff in the Office of Risk Assessment, are presently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk. OCIE has improved training and, under a newly authorized program, 268 examiners are now participating in the training and certification program offered by the Association of Certified Fraud Examiners, to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. OCIE is also recruiting additional individuals with experience in different facets of the industry, such as trading, risk assessment and compliance. These steps taken together will expand the knowledge base of our inspections staff, better enabling them to conduct oversight of complex trading strategies and products that exist in our markets today.

I have also launched an Industry and Markets Fellows Program in our Office of Risk Assessment. Through this program, we have begun recruiting fellows with extensive experience in such areas as equity and fixed income securities trading, structured products, complex derivatives, financial analysis and valuation, fund management, investment banking and financial services operations.

IMPROVING TRANSPARENCY AND INVESTOR PROTECTION

The agency is working hard in other areas as well. In the area of accounting standards, the SEC staff completed a congressionally-mandated study of fair value accounting. The staff issued guidance to financial institutions so that they can give fuller disclosure to investors, particularly with respect to hard-to-value assets. The staff has also continued to work closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets and the accounting treatment of bank support for money market funds. FASB recently took steps to clarify treatment of off-balance sheet items in a manner designed to increase market transparency.

In the area of combating false rumors and manipulative activity in the marketplace, the agency initiated examinations of the effectiveness of broker-dealers' and investment advisers' controls to prevent the spreading of false information. When concluded, the results of these examinations will be used by regulators to assist firms in crafting and implementing robust policies and procedures to prevent the spreading of false information.

In the wake of recent Ponzi schemes and other investment adviser abuses, the Commission last month proposed significant changes to the custody requirements for investment advisers. These proposals focus on the value of an independent public accountant serving as another set of eyes to better assure the safekeeping of investor assets. One proposal would require all advisers with custody or control of client

² SEC v. *Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009), Lit. Rel. No. 21036 (May 12, 2009).

assets to engage an independent public accountant to conduct an annual “surprise exam” to verify those assets exist. A second proposal would apply only to investment advisers whose client assets are not held by a firm independent of the adviser. In such cases, the investment adviser would be required to be subject to a review that results in a written report—prepared by a PCAOB-registered and inspected accounting firm—that, among other things, describes the controls in place relating to custodial services, tests the operating effectiveness of those controls and provides the results of those tests. These reports are commonly known as SAS-70 reports. The reports would include an opinion of an independent public accountant issued in accordance with the standards of the PCAOB, which will provide an important level of quality control over the accountants performing this review. In addition, advisers would be required to publicly disclose the name of the accountant conducting these reviews, so that our staff can better monitor compliance and assess adviser compliance risks. Accountants also would be required to disclose the reason for any termination or resignation from performing these reviews, which should highlight any “red flags” for regulators and investors.

At my request, our staff is also developing investor-oriented enhancements to the municipal securities area. It is time for those who buy the municipal securities that are critical to State and local funding initiatives to have access to improved quality, quantity and timeliness of information. On a related note, so called “pay-to-play” practices by investment advisers to public pension plans must be curtailed. I have asked the staff to revisit the Commission’s 1999 proposal to address harmful pay-to-play practices, and I expect that the Commission will consider that proposal this summer.

COMBATING ABUSIVE SHORT-SELLING

In my brief tenure as Chairman, the issue of short selling has outpaced any other in terms of the number of inquiries, suggestions and expressions of concern we have received. On April 8, 2009, the Commission unanimously voted to propose two distinct approaches to short selling restrictions. One approach would impose a permanent, market-wide short sale price test, while the other would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities. On May 5, 2009, the Commission held a public roundtable to solicit the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. The Commission is committed to conducting a thoughtful, deliberative process to determine what is in the best interests of investors, including examining a variety of trading and market related practices such as securities lending.

We also recognize that strong rules and vigorous enforcement are needed to curb abusive short selling and restore confidence in our markets. The Commission has been focused on the issue of abusive “naked” short selling since before my arrival in late January, and the Commission’s regulatory actions have led to a significant decline in failures to deliver securities on time following a short sale. Moreover, our Division of Enforcement has a number of active investigations involving potentially abusive short selling in a variety of contexts.

FILLING REGULATORY GAPS

In an effort towards bringing the unregulated world of credit default swaps into the sunlight, the Commission, working in close consultation with the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission (“CFTC”) and operating under the limitations of the current legislative structure, recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps (“CDS”) by I.C.H. Clearnet Ltd., ICE US Trust LLC, and Chicago Mercantile Exchange Inc. The Commission is committed to increasing investor protection and reducing systemic risk by facilitating the development and oversight of central counterparties to clear CDS.

We have also been working with the CFTC and Treasury Department to fill regulatory gaps in this area to help increase transparency and minimize risks associated with certain derivative products, including CDS, as well as market participants transacting in these products. I look forward to working with Congress to make the necessary legislative changes to ensure that these markets and market participants are appropriately regulated.

In addition, we are closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct applicable to broker-dealers and investment advisers. It is essential that comparable and effective protections be afforded to investors, whether they

turn to a broker-dealer or an investment adviser for assistance in accessing the securities markets.

Finally, hedge funds and other unregulated private pools of capital have flown under the radar for far too long. We are currently examining whether these funds, their managers or both should be subject to SEC registration and oversight, so that investors, regulators and the marketplace have more complete and meaningful information about the funds and their market activities. I look forward to working with Congress on this important issue.

STRENGTHENING SHAREHOLDER RIGHTS

We have launched an agenda of proxy reforms with a proposal approved by the Commission for public comment that would significantly support shareholders' rights to nominate company directors. Next month we will take up a broad package of corporate disclosure improvements, all designed to provide shareholders with important information about their company's key policies, procedures and practices, including compensation policies and incentive arrangements. With this additional information, shareholders will be better able to hold directors accountable for the decisions that they make. For example, the Commission will consider proposals to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission will also consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure (whether that structure includes an independent chair or combines the positions of CEO and chair), so that shareholders can better evaluate board performance. Also, shareholders should understand how compensation structures and practices drive an executive's risk-taking. The Commission will be considering whether greater disclosure is needed about how a company—and the company's board in particular—manages risks, both generally and in the context of compensation. The Commission will also consider whether greater disclosure is needed about a company's overall compensation approach, beyond decisions with respect only to the highest paid officers, as well as about compensation consultant conflicts of interests.

IMPROVING MONEY MARKET AND MUTUAL FUND REGULATION

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. The proposals will focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets, like those that unfolded last fall. In addition, we are exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value, in order to protect investors from abuses and runs on the funds.

In addition, on June 18, the SEC and the Department of Labor will hold a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become quite popular, and growth in target date fund assets is likely to continue since these funds can be default investments in 401(k) retirement plans under the Pension Protection Act of 2006. However, target date funds have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results. Returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

These returns cause concern for investors and regulators alike. I can assure you that SEC staff is closely reviewing target date funds' disclosure about their asset allocations. In addition, in connection with our joint hearing with the Department of Labor, we will consider whether additional measures are needed to better align target date funds' asset allocations with investor expectations. Among other issues, we will consider whether the use of a particular target date in a fund's name may be misleading or confusing to investors and whether there are additional controls the SEC should impose to govern the use of a target date in a fund's name.

I also have asked the staff to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Yet in 2008, rule 12b-1 was used to collect over \$13 billion in investors' funds out of fund assets. It is essential, therefore, that the SEC engage in a com-

prehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to step in and adjust our regulations.

In addition to these initiatives, the agency continues to annually review 5,000 corporate filings, over 1,000 SRO rules, and nearly 3,000 new investment company portfolio disclosures. We establish the standards for 13 securities exchanges, 4 securities futures product exchanges, FINRA (a national securities association), the Municipal Securities Rulemaking Board, 10 nationally recognized statistical rating organizations, 10 registered clearing agencies, approximately 600 transfer agents, and securities information processors. Despite the extreme volatility and uncertainty in the markets over the past year, transactions continue to trade at both record volumes and record speed.

SEC RESOURCES

The financial crisis has reminded us just how large, complex, and critical to our economy the securities markets have become in recent years. Whereas the dollar value of the average daily trading volume in stocks, exchange-traded options and security futures was \$10 billion a day in February 1989, over the last 20 years it has grown to over 25 times that size, reaching approximately \$251 billion a day in February 2009. And not only has the size of our markets exploded, the number and size of its participants have jumped as well. For example, since 2005, the number of registered investment advisers has increased by 32 percent, and their assets under management have jumped by over 70 percent to reach more than \$40 trillion as of the beginning of this fiscal year. Broker-dealer operations have expanded significantly in size, complexity, and geographical diversity, as exemplified by the 67 percent rise in the number of broker-dealer branch offices. In all, the SEC's 3,652 staff now oversee more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual funds, 11,300 investment advisers, 5,500 broker dealers, and 600 transfer agents. By comparison, other financial regulators often have close to parity between the number of staff and the number of entities they regulate. For additional detail, attached to this testimony is an appendix, "SEC Staff Levels Have Not Kept Pace with Industry Growth."

Yet at the same time that the securities markets have undergone such tremendous growth, the SEC's resources have fallen further and further behind. Between fiscal year 2005 and fiscal year 2007, the agency experienced 3 years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs. In the context of rapidly expanding markets, I believe these reductions in the SEC's staff seriously limited the agency's ability to effectively oversee the markets and pursue violations of the securities laws.

With support from this subcommittee, during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce. By increasing the SEC's appropriation for this fiscal year, approving a reprogramming of additional resources, and just recently supporting emergency supplemental funds for the agency, this subcommittee has expressed its strong support for the SEC and its mission. I am very grateful for that support.

However, even with these important steps, the number of staff with which the SEC can detect fraud, prosecute wrongdoing, ensure proper disclosure, conduct strong oversight of the markets, and take other actions to protect investors, is still significantly below the levels of only a few years ago. Under the SEC's current funding level, the agency's workforce still will fall about 200 staff, or about 5 percent, short of the fiscal year 2005 level.

I believe additional resources are essential if we hope to restore the SEC as a vigorous and effective regulator of our financial markets. The President is requesting a total of \$1.026 billion for the agency in fiscal year 2010, a 7 percent increase over the fiscal year 2009 funding level. This proposal would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance our ability to uncover and prosecute fraud, and begin to build desperately needed technology.

Specifically, these positions would help the SEC's Enforcement program enhance its pursuit of tips, complaints and other leads, thus increasing the resources the SEC can dedicate to frauds that citizens bring to our attention. They would also allow us to hire more trial lawyers and staff with specialized skills that will help our Enforcement program's efficiency, expertise and success. The Examination program would hire market experts to strengthen risk-based oversight of the investment management industry and expand its inspections of credit rating agencies. Our Division of Trading and Markets would strengthen its oversight of entities that play critical roles in our markets, such as broker-dealers, exchanges, clearing cor-

porations, and other self-regulatory organizations. And the President's Budget would allow us to expand our Office of Risk Assessment by fully funding our program to bring in seasoned industry professionals to help uncover hidden risks to investors.

Although expanding our workforce is a critically important step, I believe we also must give our staff better tools to conduct oversight of vast financial markets. That is why the President's request for fiscal year 2010 also contains funds for additional investments in our information systems. Investments in new systems have dropped by more than half over the last 4 years, and as a result the SEC has a growing list of technology needs that have gone unfunded. With the additional IT funds provided under the President's Budget for fiscal year 2010, I would plan to focus on several key projects:

First and foremost, we would use additional funds to enhance our systems for handling tips, complaints and referrals. Although the SEC has a number of different processes to track this kind of information, there is no central repository or system through which this information comes together to ensure it is handled consistently or appropriately. Nor is there any present capability to mine the data to find connections, patterns or trends that would enable us to more intelligently focus our enforcement efforts.

The SEC also plans to improve our ability to identify emerging risks to investors. We have many internal data repositories from filings, examinations, investigations, economic research and other ongoing activities. But the SEC needs better tools to mine this data, link it together, and combine it with data sources from outside the Commission to determine which firms or practices raise red flags and deserve a closer look.

Finally, we would invest in our multi-year efforts to improve the case and exam management tools available to our enforcement and examination programs. These systems would give our senior managers better information on the mix of cases, investigations, and examinations, so they can apply resources swiftly to the continually evolving set of issues and problems in the markets. In addition, these tools will provide better support for line staff in these programs, so they can be more productive and better able to match the sophisticated systems used by the financial industry.

I came to the SEC to shape public policy in the interest of investors and to strengthen our enforcement program. The things I have described in this testimony are important to those efforts. But what I have also discovered in the past 4 months is that much attention needs to be focused on the internal operations of the agency, the processes that guide our work, the agency's infrastructure and how we are organized. I have been disappointed to find that in some areas of our internal operations, we fall short of what the taxpayer has a right to expect of us, and what our employees have a right to expect of a world class organization. I am committed to a complete review of areas large and small, including FOIA operations, call centers operations, records management, and others, to ensure that we meet the highest standards and that we are fully supporting the important work of our employees in these operations. Doing this will take time and energy and focus. To ensure that we do it well and thoroughly, I intend to bring in a Chief Operating Officer to manage the process. Federal agencies do not manage themselves; we must be actively engaged in that process everyday.

In one area, we have already made progress: we are moving to build an internal compliance program that is second to none. The public appropriately holds the SEC to a very high standard for integrity and professionalism, and we hold ourselves to that very high standard as well. That is why I have initiated several steps to guard against inappropriate securities trading by SEC staff, as well as to avoid any appearance of inappropriate trading. Among other steps, the agency has drafted new internal rules that would prohibit staff from trading in the securities of companies under SEC investigation, regardless of whether an employee has personal knowledge of the investigation, and require preclearance of all trades. The SEC also is contracting with an outside firm to develop a computer compliance system to track, audit and oversee employee trades and financial disclosures in real time. Finally, I consolidated responsibility for this area within our Ethics Office and authorized the hiring of a new chief compliance officer. To further enhance the SEC's financial controls, the agency also will continue its multi-year efforts to build an automated, integrated financial management system.

I want to thank you for your continued strong support for the SEC and its critical mission. I believe the steps I have outlined here—strengthening our enforcement program, enhancing risk-based oversight of the markets and leveraging technology—are essential for restoring investors' confidence in both the SEC and in our Nation's securities markets.

I would be happy to answer any questions you may have.

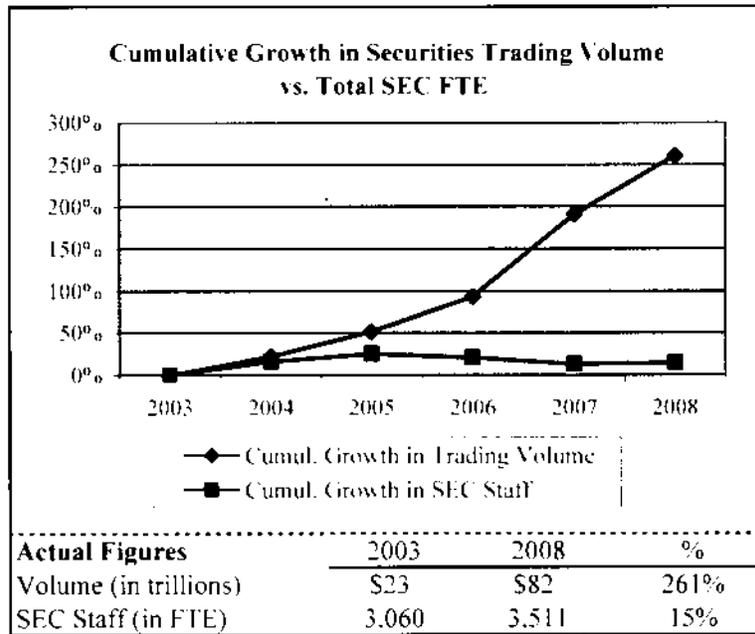
APPENDIX: SEC STAFF LEVELS HAVE NOT KEPT PACE WITH INDUSTRY GROWTH

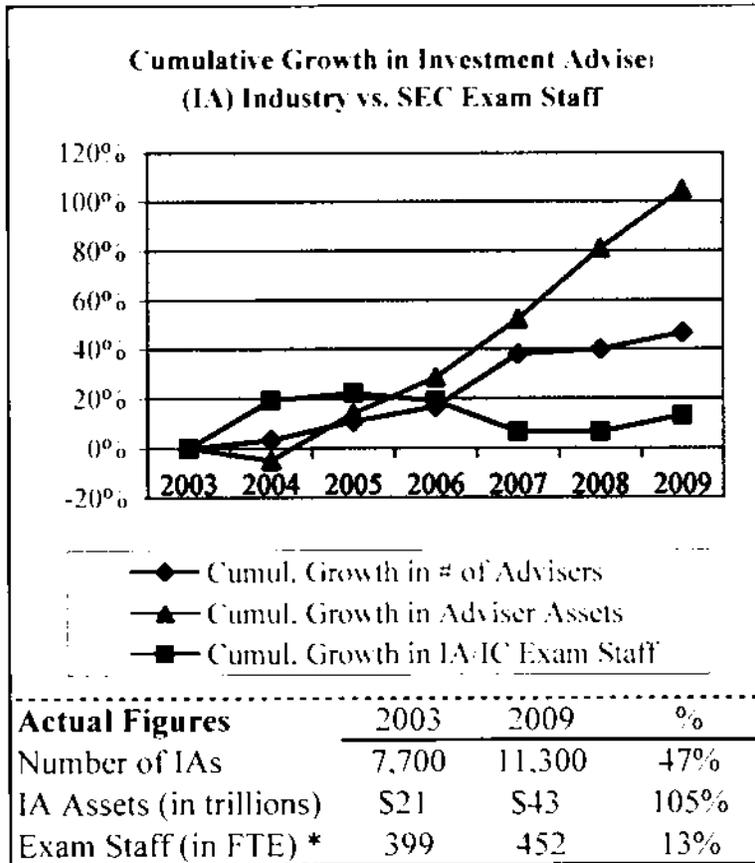
(Tables show cumulative growth relative to 2003 levels)

The SEC's staff of 3,652 FTE (estimate for fiscal year 2009) oversees more than 35,000 entities. These include:

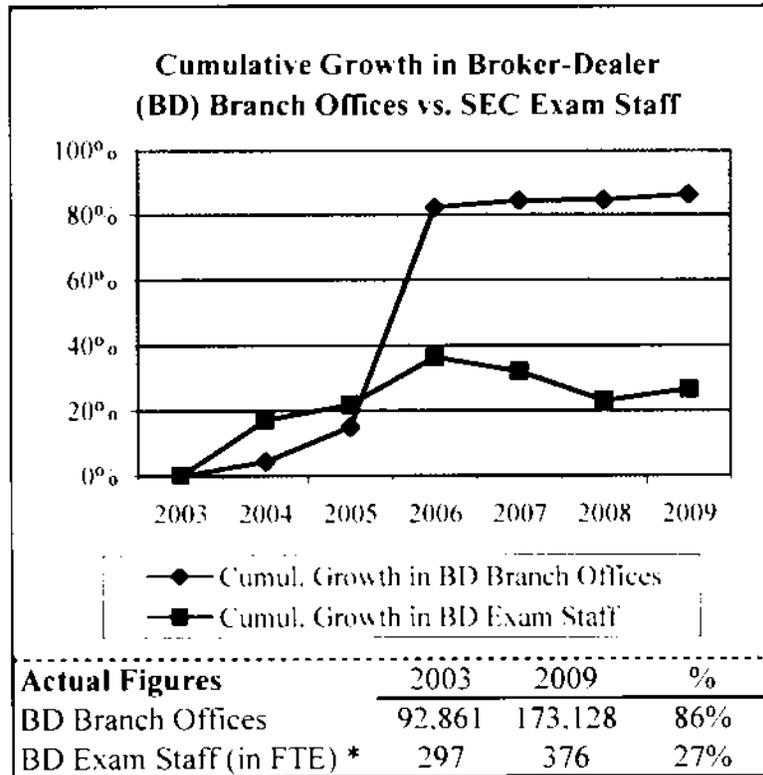
- 11,300 investment advisers;
- 5,500 broker-dealers;
- 8,000 mutual funds;
- About 600 transfer agents;
- Clearance and settlement systems;
- 11 securities exchanges;
- 12,000 public companies;
- 10 credit rating agencies;
- FINRA, MSRB, and PCAOB.

The following charts display how various aspects of the markets have grown since 2003, relative to the SEC's staff:





* The FTE figures for FY 2009 are estimates.



BUDGET AND WORKFORCE OF THE SEC

Senator DURBIN. We'll have 5-minute rounds here, and I'm sure we'll have several questions.

It seems to me that there are two things we're dealing with here just on the surface. First, the number of people working in your agency. It appears that over the years, as Senator Collins noted, we've allowed the number of professionals working there to decline in real terms and certainly decline precipitously in relation to the volume of trade that you have to keep an eye on.

Between 2005 and 2007, the SEC lost 10 percent of its employees, if you can imagine at that moment in time, undermining the agency's ability to oversee the markets, and at the same period of time, the market ballooned in size and complexity.

Registered investment advisors grew 32 percent, assets jumped by over 70 percent, and so we're seeing the caseload or at least the area that needs to be regulated is growing and the number of people to keep an eye on it is diminishing.

So there is, in the first instance, the question of the right number of people working at the agency, and the second issue goes to—I don't know how to characterize it—I guess the internal culture of the agency.

Bernard Madoff was a wake-up call. The fact that this man could swindle as many people as he did with impunity for so long to me is nothing short of amazing.

According to SEC data, in fiscal year 2008, the SEC staff handled over 600,000 tips sent by individuals to your Enforcement Complaint Center. I did a calculation. I think that's more than 2,000 a day for every business day. People sending in items you ought to look at. Well, that to me is an overwhelming number and perhaps you could put it in some kind of perspective.

Now, some have taken a look inside your agency and asked whether the enforcement function within the agency is a healthy one. Is there a risk-averse culture within the SEC to step up and say, you know, we ought to take a look at this Mr. Madoff or people like him?

So let me ask you at the outset, number 1, what would be the optimal number of people that you believe you need to do an effective job at the SEC in light of the volume of business that you have to regulate, and second, do you perceive a cultural problem within the agency when it comes to enforcement?

Ms. SCHAPIRO. Thank you very much, Mr. Chairman.

I think you've really summarized very well with respect to the staffing pressures on the SEC, the current situation.

With over 35,000 regulated entities and 3,700 staff, it's a job that we really can't do in the way I think the public would like to believe we can do in the sense of routine onsite presence in many regulated entities. That's going to really require that we leverage third parties.

So, for example, in the rules I discussed related to the custody of customer assets by investment advisors, a huge problem in the Madoff area, we're going to rely on PCAOB-registered accounting firms to leverage our capability to ensure the customer assets are being protected by the custodians and by the investment advisors, and we will look for every opportunity we can to leverage third party resources.

But at the end of the day, we do need significantly more staff, I believe, over the next several years to keep up with the growth and the complexity of this industry, and if there are additional responsibilities as a result of regulatory reform that accrue to the SEC in the context of hedge funds, credit default swaps or other areas, that, of course, will require sufficient additional resources because we can't stretch any thinner than we already are.

So I do believe—and if you look at our 2011 budget request, you will see we've asked for a significant ramp-up in the number of full-time equivalents (FTE), close to 400 FTE and 1,000 new positions, and I believe that if we're able to achieve that number in 2011 or over the course of the next several years, that will go a long way toward getting this agency to the appropriate size to handle the job that's in front of it.

I don't think there's any danger that we're about to become too big in any event.

I think, with respect to your second question, the Madoff fraud is a tremendous tragedy. It's really a tragedy of epic proportions and I think it really will put the onus on this agency to prove that it is capable of managing the responsibilities that it has been given

under the law and it's really critically important for us to ensure that both our culture, our operations, and our procedures, our staff and our skill sets are up to the task.

You pointed out, for example, that we get somewhere around 600,000 to, in peak years, 1½ million tips a year. We can't manage those that come into the organization through a wide variety of entry points. We don't have databases that are connected so that we can do a trend analysis of those tips and complaints or connect that data to external sources of data to see what might be developing more broadly in the marketplace.

Right after I started, I brought in the Mitre Corporation's Center for Enterprise Modernization to do a complete review of how we handle tips and complaints. They've concluded the first round of their work and we're now in the implementation phase of some short-term and intermediate-term remedies and processes to help us manage tips and complaints.

But it's also about leadership and it's about freeing our Enforcement Division to do the kind of job that I know they're capable of doing.

I was at the SEC 15 years ago when the agency had a really first-class reputation for aggressive enforcement and I know we're capable of that again. We have a new Enforcement Director who's very committed to bringing large cases in a timely way that have the maximum investor protection impact.

It's about enabling our enforcement staff through technology and the right skill sets to bring those kinds of cases, that when a whistleblower presents them with information, as had happened in the *Madoff* case, they have the ability to understand it and pursue it. It's about being a little bit humble about the information that comes to us and appreciating that there may be real value in what's being presented to us.

We're also going to seek whistleblower legislation to enable us to reward whistleblowers, as the Internal Revenue Service (IRS) and other agencies do, when they bring us well-formed cases and documentation, a fraud that we can then pursue, and it's about filling the regulatory gaps, through such as the custody requirements I just spoke of, so that we are sure that the regulatory regime, coupled with aggressive enforcement, coupled with the tools and the skill sets, combine to create an agency that's absolutely committed and focused on investor protection.

I'm sorry. That's a very long answer.

Senator DURBIN. No. It's a very good answer, and I thank you for it, and I'm going to turn to Senator Collins and return in later rounds.

Senator COLLINS. Thank you, Mr. Chairman.

Ms. Schapiro, you talked about the increased number of positions that you have requested as part of the fiscal year 2011 budget, but in fact, the President's budget for this coming fiscal year does not allow you to hire any new positions, is that correct?

Ms. SCHAPIRO. That's correct, Senator. The increase in the 2010 budget covers the annualized costs of the increases in the fiscal year 2009 budget that we were able to have as a result of the approval of our reprogramming requests and taking \$17 million of

unobligated funds from prior years, dedicating those to staffing, additional staffing in 2009.

The annualized costs of those additional 50 positions that we're bringing on this year are the increase in the 2010 budget.

Senator COLLINS. Do you need new positions for the upcoming fiscal year?

Ms. SCHAPIRO. Well, I would say that we're, first of all, extremely grateful to the President for the increase in the 2010 budget and it's a meaningful increase for this agency, and as I pointed out, 2011 we sought a much greater increase.

The opportunity to start to move toward that 2011 budget earlier would be a wonderful opportunity for us to bring that number of staff on over a 2-year period rather than all in 2011, if Congress ultimately approves that number.

Senator COLLINS. Because I am troubled that the current funding level supports a staff that is 5 percent lower than your peak level back in fiscal year 2005.

If you look at the growth of regulated entities and if you look at the amount of money involved, if you look at the number of American families who now have savings in the stock market, the fact that these staffing levels are below what they were 5 years ago is troubling to me.

So are you saying that it would be helpful to be able to ramp up those staffing starting in the next fiscal year rather than waiting to fiscal year 2011?

Ms. SCHAPIRO. Absolutely, it would be helpful. The reprogramming request, in addition to allowing us to get a little bit of a jump on 2010, enabled us to do some technology investment.

We need fundamentally more investment in technology at the SEC to support our Enforcement and Examination Programs and we can use more boots on the ground in Enforcement and Examination, absolutely.

INVESTOR PROTECTION AND EDUCATION

Senator COLLINS. Aggressive enforcement is absolutely critical, but there's another way that's important for protecting investors, particularly smaller investors who may be less sophisticated in choosing their investments, and that is through a robust education effort.

You've spoken a lot about the need to protect investors and I know that in my State, I've seen thousands of individuals who have seen their retirement nest eggs shrink, money set aside for their children's college education virtually disappear, and they're wondering what can be done about it. They're seeking more information.

Several years ago, the SEC used to conduct very valuable educational sessions, town meetings, outreach to seniors groups.

What are your plans to reach out to investors, particularly small investors or senior citizens, in two ways; one, to help them better understand risk and suitability requirements, but, two, to help them spot scams?

Ms. SCHAPIRO. It's a wonderful question, and I'm very committed and personally quite passionate about investor education and had a program at my former employer, FINRA, as Senator Tester

knows, where we did investor forums which the SEC used to do years ago around the country and to great success and with tremendous participation all over the country.

The SEC has a small program that does that now. Commissioner Walter in fact did an investor forum just last week with our Boston office in the State of Maine.

My plans would be, given sufficient resources, that we dramatically increase that program, that we enable our offices around the country to provide local education in senior citizens centers, community centers, local high schools, and that we really take a leadership role in the Federal Government in educating investors about the kinds of questions they need to ask when they're being offered investment products, about the kinds of scams and pitfalls that they need to be on the alert to.

I'm very concerned, given the current environment and the amount of money people have lost in their retirement plans and in their other investments, that they will be reaching to try to make that money back through some particularly risky investments. I have no doubt that the scam artists have already figured this out and are beginning to prey on people's real fears about their financial futures.

I think the SEC can play a critical role here, bringing together other agencies of the Federal Government but also on its own, reaching out very directly as well as through the development of content put on websites and in investor forums.

Senator COLLINS. Thank you. Glad to hear it.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

Chairman Schapiro, you come into an agency, the SEC, that has been around about 75 years and to be honest, from my perspective, probably come into it at a time when it's hit an all-time low as far as both morale and effectiveness. So you've got to rebuild this agency, I think, maybe not from the ground up but from the foundation up.

We've talked about manpower levels. If you have the technology that you spoke about, do you have a figure in mind about what the right number of people are for this agency, considering the massive workload?

Ms. SCHAPIRO. I think it's very hard to give an exact number. As I said, our 2011 budget request seeks 1,000 additional positions which would take us to just under 5,000. That would still be smaller, for example, than the Federal Deposit Insurance Corporation (FDIC) which regulates about 5,000 to 6,000 banks.

Senator TESTER. Okay.

Ms. SCHAPIRO. I do think there's also practical limitation on how many people you can just bring on board and train—

Senator TESTER. Right.

Ms. SCHAPIRO [continuing]. At any given time. The faster that we can move toward a substantial increase like that I think the better.

Senator TESTER. Okay.

Ms. SCHAPIRO. It also depends largely on our ability of effectively utilized technology to save on human resources.

Senator TESTER. Right on. Consumer confidence is one of the things that everybody's concerned about. Nobody—you know, we've lost a bunch of money. People's confidence is shaken.

RESTORING INVESTOR CONFIDENCE

What do you see as being two or three of the major things that you have to do in your agency to have consumer confidence back at a level that's reasonable, and, quite honestly, what do you see we need to do, the two or three things that we need to do to help re-establish consumer confidence with the groups that you regulate?

Ms. SCHAPIRO. I think it's a great question. I think enforcement is just a part of what we do, but it's a very visible part, and I think it's really critical for investors to see that there is a cop on the beat who's trying to ensure that the playing field is level, that the insiders aren't taking advantage of the rest of the participants in the marketplace.

So we need to have a very timely enforcement response to the problems that arise in the marketplace and short of doing that, I think people won't have confidence. We can write all the rules we want, but if nobody's enforcing them, we're not going to restore investor confidence.

I think investors also need to have complete confidence in the transparency of corporate disclosure. They need to believe that the companies in whose stock they are buying are getting them the accurate numbers and the accurate disclosure and information about that company's prospects so they can make informed decisions about where to put their money.

And I think we have to have a focus on consumers issues, on mutual funds sales, on sales practices generally, on the issues around fees and fee structures and disclosures that investors really care about at the end of the day.

We'll be announcing later this week the creation of an Investor Advisory Committee for the first time in many, many years at the SEC that will give investors a regular way to interact with the Commission on policy issues that are of interest to them.

I think we have to reorient everything we do toward rebuilding the investor confidence in both the agency and in the fairness of our markets.

Senator TESTER. What do we need to do, Congress?

Ms. SCHAPIRO. I think supporting the agency, quite honestly, as the appropriators with sufficient resources to accomplish what we need to do and hold our feet to the fire that we're delivering on the commitments that we're making to the American public.

Senator TESTER. Have you been able—I mean, there's been talk about the future roles of the SEC, the CFTC that we'll hear from shortly, after a regulatory modernization has been done.

Assuming that that goes forward, can you talk about the challenges, opportunities, possible consequences of merging your two agencies?

Ms. SCHAPIRO. Sure. And, you know, I have the unique position of having been Chairman of the CFTC and now Chairman of the SEC. So in honesty, I can tell you I've argued both for and against merger over the years.

I think it's obviously a decision that's ultimately for the Congress about whether or not to combine the two agencies. Short of that, I believe that with Gary as Chairman of the CFTC that we can have an incredibly positive and constructive working relationship, to ensure that products and practices don't fall between the cracks of the two agencies and that we don't leave large swaths of the financial markets unregulated and unaccountable to the American public—

Senator TESTER. Do you think that would be—excuse me. Do you think that would be done better if you were combined?

Ms. SCHAPIRO. I think—in my personal view, there is a logic and an efficiency that can be achieved from the merger of the two agencies, but short of that, I also think that the two agencies can do a better job of working together to ensure the protection of investors.

Senator TESTER. My time is up, but we'll be back.

Senator DURBIN. I was just advised by my colleague that there's a vote on and I'm going to try to continue asking until someone returns, but I ask the indulgence of our witness and those in the audience as we try to balance a few things here.

ADDRESSING RESOURCE CONSTRAINTS

The numbers of investigative attorneys at the SEC decreased 11.5 percent between fiscal years 2004–2008 and some believe that that's resulted in delayed cases, reducing the number that can be brought to trial and potentially undermining the quality of cases that are pursued.

How have resource constraints impacted the effectiveness of the SEC?

Ms. SCHAPIRO. There's no question but that—and there's a recent Government Accountability Office (GAO) report that suggests this, as well, that the resource constraints have hindered the ability of the Enforcement Division to pursue as many cases in as timely a way as I would like to see.

In addition, there are some procedural difficulties placed in the path of the Enforcement Division over the last several years that slowed cases down and discouraged, if not explicitly, implicitly seeking penalties from corporate issuers in certain kinds of cases, and we've eliminated those hurdles and cases can be started much more quickly now. Investigations can be pursued with the approval of one commissioner, not the full Commission sitting in a meeting.

We've eliminated what was called the Penalty Pilot Program completely and we are reorganizing the Enforcement Division under the leadership of our new Director in a way that we hope will eliminate some layers of management and some of the stovepiping that's existed over the years and allow us to be more nimble and more aggressive, pursuing much larger cases, particularly those arising out of the financial crisis.

Senator DURBIN. On another issue, there was a mindset for a long period of time that as long as the economy was expanding and wealth was being created, we didn't dwell and ask a lot of embarrassing questions, but with the downturn in the economy, downturn in the fortunes of many families and the investment of our Federal Government into many of the largest businesses in Amer-

ica, there appears to be an awakening on the part of the average person about how many corporations are being managed and particularly in the area of executive compensation.

CORPORATE GOVERNANCE

I won't go into chapter and verse about bonuses given to executives who have nothing to show for it, other than failure, but let me ask you, what is the SEC currently doing to improve the accountability of corporate directors and enhanced disclosure of executive compensation?

Ms. SCHAPIRO. Mr. Chairman, I've made corporate governance one of my highest priorities in the last 4 months. We are engaged in a couple of things.

First of all, in May we approved for comment a proposal that will facilitate the ability of shareholders to nominate on the company's proxy directors to serve on the corporate—on the company's board and it's out for comment now. It will be highly controversial, but if ultimately approved and not challenged in court, it will greatly facilitate the abilities of shareholders to elect nominees to corporate boards and thereby hold directors more accountable for their oversight of the corporation.

With respect to compensation in particular, as you know, we already require disclosure of all plan and non-plan compensation by the senior-most officers of a company.

Next month we will be considering amendments to the compensation disclosure rules that will simplify something called the summary compensation disclosure table to provide more information there about compensation.

It will require disclosure about the overall compensation approach within the company. There will be enhanced disclosure about the use of compensation consultants who are sometimes in a conflicted position in advising both the compensation committee and the company's management, and we're going to require disclosure about the linkage between compensation plans and risk-taking by executives, traders and others within the company, so that investors will be able to understand how risk-taking which was such an important component of the financial crisis has been potentially incentivized in some companies.

CREDIT RATING AGENCIES

Senator DURBIN. On another issue, in late 2006 the Credit Rating Agency Reform Act gave the SEC exclusive authority over rating agency registration and qualification. In the less than 3 years since enactment the SEC has undertaken no fewer than five rulemakings to implement the law. These rules, which are all still relatively new, extend from registration and recordkeeping to disclosure and managing conflicts of interest.

Yet, even though the credit rating agencies were under SEC's purview, rating agency performance in the area of mortgage-backed securities backed by residential subprime loans and the collateralized debt obligations linked to such securities has shaken investor confidence to the core.

It used to be that credit ratings were kind of like the gold standard in terms of whether you could trust a business to be in solid financial shape. Well, I think a lot of questions have been raised.

What are you doing at the SEC now to restore consumer and investor confidence, and what improvements are needed in the way that you monitor credit rating agencies?

Ms. SCHAPIRO. There's no question but that credit rating agencies played a significant role in facilitating, I guess, in some ways the financial crisis.

The agency has engaged, as you point out, in many rulemakings, most recently the rule in 2008 which required a series of disclosures about performance statistics, the different kinds of models that were used for initial ratings versus surveillance ratings, documentation, disclosure of conflicts and so forth.

The Credit Rating Agency Reform Act, which Congress passed in 2006, specifically does not allow the agency to regulate the substance or the procedures or the methodologies of the rating agencies and something we're looking at is whether we need to ask Congress to reopen that legislation to provide greater authority.

Senator DURBIN. Who does?

Ms. SCHAPIRO. Nobody. But nonetheless, despite the limitations in the law, we are looking at doing a couple of things.

One is my perhaps my greatest concern in this area is something called ratings shopping which allows the creator of a structured product to get preliminary ratings from multiple rating agencies and then select the one they want to rate the product, presumably that being the highest rating they've gotten.

Senator DURBIN. Wish I could have had that for my report card in grade school.

Ms. SCHAPIRO. Don't we all?

Senator DURBIN. Shopping teachers.

Ms. SCHAPIRO. Exactly. If you'll give me an A, I'll take your class is what it amounts to.

So we're looking at what we can do with respect to rating shopping. Removing references potentially to ratings in the Federal securities laws and regulations which gives an air of credibility and respectability to ratings that perhaps they don't entirely deserve, looking at whether we should require different symbols for rating structured products versus rating plain vanilla corporate debt, and we're looking at more detailed disclosure about how ratings have performed over time.

So there's some things the SEC clearly can do and we are doing. We held a roundtable with rating agencies just about 1 month ago to explore some of the failures of the different business models and some of the—not the failures of the different business models but the different business models, some of the other failures that have become clear over the last year.

We're moving ahead with what we can do and we will come back to Congress if we believe at the end of the day we need more authority.

Senator DURBIN. Thank you. I'm going to ask that the subcommittee stand in recess for just a few moments and as soon as Senator Collins returns, I'm going to ask her to resume the hearing. I apologize, but it just so happens we have a rollcall vote.

The subcommittee will stand in recess.

Senator COLLINS [presiding]. The hearing will reconvene.

In Senator Durbin's absence, he's permitting me to continue the hearing. I'm certain he'll be back very soon. He's just voting.

Ms. Schapiro, last September the SEC's inspector general issued a report on its investigation of the Consolidated Supervised Entity Program, the CSE Program, through which the SEC monitored the five major investment banks.

This inspector general report found that the SEC has severely understaffed its CSE Program and thus could not effectively manage its responsibilities to monitor or question these investment banks.

As you know, I'm particularly concerned that an investment bank like BearStearns was allowed to have a leverage ratio of 30:1, truly astonishing, and yet it appears that there was not a system in place, other than a very loose voluntary system that the SEC had, to monitor these banks, and in many ways this report was truly prescient since just a few months after it was issued none of these investment banks existed anymore. They all had either failed, been acquired or merged into bank holding companies.

REGULATION OF LARGE INVESTMENT BANKS

Let me ask you a number of questions about this. First, does the SEC have the right mix of staffs to conduct the kind of oversight of a large investment bank? A lot of the SEC's employees are attorneys which is obviously very useful and helpful on the enforcement side, but does it need more auditors, more economists to have the expertise to analyze complex financial data and risk models? So the first question is the mix of expertise.

Ms. SCHAPIRO. I believe that we haven't historically had enough financial analysis experience, experience with structured products and complex derivative products.

In the last couple of months that's been an area of focus for recruitment, not just in the Enforcement Program but also in the Trading and Markets Division which has responsibility for broker-dealer risk oversight. So that even though the CSE Program is discontinued, there are still a large number of—not maybe a large number but a number of large investment banks and broker-dealers for whom the SEC still has responsibility.

That's an area that we are building and increasing our capability in in a very conscientious and sort of directed way and have been working on over the last couple of months. It's really important for us to have that capability.

Even with the presence ultimately of a systemic risk regulator, that's the result of regulatory reform, it will be important for the SEC, as the day to day regulator of over 5,000 broker-dealers, to have the capability to really understand the financial and operational status and condition of those brokerage firms.

Senator COLLINS. Second, how should—I realize these large investment banks don't exist any more but they could reappear. How should they be regulated for safety and soundness?

I cannot imagine a federally or State-chartered bank being allowed to have a leverage ratio of 30:1.

Ms. SCHAPIRO. I think the answer is they need to be regulated on a consolidated basis. So that, as you know, the securities laws are generally geared toward the protection of customer assets within the broker-dealer, but there are affiliates of the broker-dealer, there's a holding company structure, there are a lot of other entities where significant risk can be taking place, and it's important that the regulator of the entire entity have a view into what's going on in all of the related parts of the operation, so not just in the broker-dealer but also in the holding company affiliates and subsidiaries.

It is that consolidated view that will allow our regulator to make a judgment about whether leverage is excessive, capital is sufficient, the quality of management across the enterprise is up to the task.

Senator COLLINS. Another reform that we need is the ability to identify and prevent what I refer to as regulatory black holes, and the emergence of credit default swaps or other exotic and poorly disclosed derivatives certainly indicates that the current system has not been sufficient to prevent gaps in regulation of products or practices that can have consequences for the entire financial system. That's why I support having a council of regulators to look at systemic risk.

ROLE OF A SYSTEMIC RISK REGULATOR

What do you think are the advantages and disadvantages of a council approach versus vesting in the Federal Reserve the authority to be the systemic risk regulator?

Ms. SCHAPIRO. Well, I'm very much in agreement that the existing regulatory regime is riddled with holes and that there are large parts of the financial marketplace that were really not under the regulatory umbrella at all or in any meaningful way and credit default swaps is an example. Hedge funds and some other private pools of pooled funds would fall into that category, as well.

As you know, I like the concept of a council, whether it's a stand-alone council or in conjunction with a systemic risk regulator, because it brings a diversity of perspective that I think is really important to identifying where gaps may be arising, where new products may be being created in the intricacies between regulatory authorities, so that we can avoid those potentially harming the system.

And when you have a council of regulators, where you've got securities regulators, for example, which is very much focused on investor protection and transparency and bank regulators very much focused on prudential standards and safety and soundness, and insurance regulators with yet another perspective, I think you have a better chance of capturing the entire financial landscape and the potential places where those new products are arising, where those new gaps are being created.

At the same time I think there needs to be the ability, whether it's a council or a single system risk regulator or a combination, to step in and raise standards when necessary, where the functional regulator may not be aggressive enough in requiring higher capital standards or reining in leverage, that there be the ability ultimately to protect the system, to force those kind of changes.

Senator COLLINS. Thank you, Senator Tester. It's nice being temporarily chairman.

Senator TESTER. Thank you. Thank you, Senator Collins, and you're doing a fine job, I might add.

ENFORCEMENT OF THE SECURITIES LAWS

Secretary Schapiro, I'm sure you read the article yesterday in the Washington Post that dealt with enforcement actions of the SEC over the past few years. If that article's true, it is more than just a little bit distressing.

You have stated the imperative to take the handcuffs off the Enforcement Division. That article yesterday would imply to me that I don't care how much money we put at the agency, if people on top are making arbitrary decisions about how to not do their job appropriately, no amount of money is going to make it work correctly.

You're not going to do that, I know that. I've met you and long before when you were in FINRA, as you stated in your opening statement, in Montana and did a fine job education-wise and you have done a fine job in this position.

But could you just give me a little bit of insight on how this budget would help you accomplish the goal of taking the handcuffs off the Enforcement Division?

Ms. SCHAPIRO. I'd be happy to. I should say that in my 4 months at the agency, I talk a lot about enforcement. I've done some town halls with the staff. I e-mail with the staff.

I will tell you that the response has been tremendous eagerness and enthusiasm on the part of employees to get back to what we do and what we can do so well and—

Senator TESTER. Good.

Ms. SCHAPIRO [continuing]. Particularly in the enforcement context.

I think what the budget will enable us to do is have more people to bring the cases that need to be brought. We are not in danger of running out of cases. So on a very simplistic level, more people will enable us to do that.

Bringing in the right skill sets so that we're not risk averse, so that we're not afraid to tackle the most complex trading strategies or the most complex products or the most complex frauds will be important. So we need to train our people better in more sophisticated methodologies. We need to bring in the right kinds of skill sets, as well, and we need to support our people with technology.

The amount of data that comes into the agency that is unmanageable, even in the course of one major litigation, is extraordinary and we have our people wasting their times archiving e-mails and dealing with millions and millions of records when we should be able to rely almost solely on technology to do that.

We need technology to help us sort out the tips and complaints that we get, as I spoke about earlier.

Senator TESTER. The ranking member talked about potentially inadequacies of this budget. In a previous line of questions, you said you can't bring on everybody you need because it's simply impossible to manage that influx of people.

Is the budget adequate to get to where you need to go? I'm sure you have goals, either written or mental, where you want this agency to go. Is this budget adequate to get you where you need to be a year from now?

Ms. SCHAPIRO. As I said, we are genuinely grateful to the President for the increase the 2010 budget represents over 2008 and 2009. We've asked for a very significant increase in 2011 and the ability to get to that number sooner, we could handle, and I think it would make a difference in our ability to do our job.

REGULATION OF SHORT SELLING

Senator TESTER. Okay. Uptick rule. Can you discuss the Commission's effort to reinstate the Uptick rule, what's the likelihood, timing and opposition to that?

Ms. SCHAPIRO. I would be happy to do that. This is an issue of enormous, enormous public interest, and it's an issue of investor confidence, as well.

As you know, the SEC took the Uptick rule off a couple years ago after careful study and evaluation. In some ways it was a model rulemaking to eliminate it.

Nonetheless, that coincided with dramatic increases in volatility in the marketplace and investors have been clamoring for us to revisit this issue. In April, the Commission voted unanimously to seek public comment on two different approaches to short selling.

One is essentially the reinstatement of the Uptick rule as we used to know it, with some variations. The other is a short sale circuit-breaker that would be kicked into effect if the price of a stock declined by, say, 10 percent in a day, no short selling thereafter for a period of time.

We've already gotten 3,000 comment letters. The comment period closes in about 2 weeks, and then we will wade through those comment letters and hopefully bring back to the Commission a proposal for consideration.

At the same time we're looking at a couple of other issues. There's a rule, it's a temporary rule that expires in July that's had a very, very positive effect on eliminating or diminishing the fails to deliver in securities and short sales, requiring them to be closed out the next day. I expect the Commission will make that a permanent rule this summer, and we're looking at some other issues, like the potential for pre-borrow requirement.

So we are actively focused on short selling and will continue to do so.

Senator TESTER. Do you anticipate that the proposal you're going to take back to the Commission will be voted on when?

Ms. SCHAPIRO. I think we're looking at August for a vote. The comment period closes toward the end of June. With 3,000 comment letters at this point, I expect significantly more and we'll have to evaluate those, so some time this summer.

Senator TESTER. After the Commission votes on the rule, is it typically an immediate effective date?

Ms. SCHAPIRO. Generally not, if it requires technology changes at either exchanges or brokerage firms.

Senator TESTER. Would this?

Ms. SCHAPIRO. Yes, the reinstatement of the Uptick rule requires significantly more technology work than the circuit-breaker would.

Senator TESTER. Okay.

Ms. SCHAPIRO. So it could be quite dependent upon which of the two approaches.

Senator TESTER. One last and it has to do with this. Who's opposing the Uptick rule from going back into effect?

Ms. SCHAPIRO. I haven't been through the comment letters, to be honest, but I would say historically there's certain kinds of algorithmic traders, some kinds of hedge funds that are large short sellers that oppose it. There are—

Senator TESTER. That are for the most part unregulated at this point in time, right?

Ms. SCHAPIRO. That might be right.

Senator TESTER. Okay.

Ms. SCHAPIRO. There are others who believe that short selling plays a very legitimate role in the marketplace in terms of adding liquidity. It has impacts on options market-makers and others. So there is opposition to reinstatement.

I think the pure weight of the comment letters will tell us that there is much more support for doing something, whether it's the Uptick rule or the circuit-breaker.

Senator TESTER. Thank you.

FEE COLLECTIONS BY AND FUNDING OF THE SEC

Senator DURBIN [presiding]. Thank you. Chairman Schapiro, just for some perspective here, the SEC is fairly unique in that it collects a lot of money in fees and if I'm not mistaken, that number is somewhere a little north of or around \$1.4 billion, is that correct?

Ms. SCHAPIRO. The 2009 expectation is, yes, about \$1.35 billion.

Senator DURBIN. Okay. And the appropriation for your agency is around \$1 billion, a little over \$1 billion.

Ms. SCHAPIRO. Yes, 2009 \$916 billion, including the reprogramming request.

Senator DURBIN. So you are a cash generator—

Ms. SCHAPIRO. We are.

Senator DURBIN [continuing]. In terms of the revenues into the Treasury.

Ms. SCHAPIRO. And historically a very significant cash generator.

Senator DURBIN. And if the argument can be made that the industry is paying your agency to do its job and we've started this testimony here today arguing that you needed more people to do your job, it might be fair for those who are being regulated saying we're doing our part, in fact we're sending you about 40 percent more than you're actually spending in this agency.

Would that be a fair comment?

Ms. SCHAPIRO. It might be.

Senator DURBIN. Okay. Well, this concerns me because if we were going in the other direction, we'd be arguing, well, we need to come up with some revenue source here to provide the regulatory structure to make sure that the Government's doing its job, but in fact the marketplace that you regulate is creating the revenue opportunity.

Ms. SCHAPIRO. That's correct, and actually that doesn't include penalties and fines that are paid into the Treasury in those instances where we don't create a fair fund to distribute back to investors. So there's actually additional funding over the fee generation.

Senator DURBIN. Okay. Let me go to a few more specific questions.

Broker-dealers who sell stocks and bonds on commissions and investment advisors who offer advice are regulated under different Federal laws. The key difference is the rules governing their standard of conduct. Investment advisors held to a fiduciary standard which requires them to make investment decisions in the best interests of their clients. Brokers, in contrast, are held to something called a suitability standard under which they can sell securities as long as they are suitable to their clients.

Interesting little distinction there, but the variations between brokers and advisors has been blurring in recent years and it's raised concern among some regulators that customers won't be able to tell the difference.

I understand that you're taking a look at this.

Ms. SCHAPIRO. Absolutely. There's really no good reason for people not to get the same fiduciary protection and the same standard quality of regulation from people who are essentially giving them the same service but are called by different names.

Senator DURBIN. Let me ask you a question. First, let me preface it by saying I asked my staff this. I said, now is this for Chairman Schapiro or Chairman Gensler. They said, well, you better ask her. So here's a hedge fund issue for you.

The Pension Protection Act of 2006. Would this be your jurisdiction?

Ms. SCHAPIRO. The Pension Protection Act is largely administered by the Department of Labor, but there are elements that intersect with the SEC.

Senator DURBIN. Okay. Let me give you the situation. You tell me if this is something that you think falls in your jurisdiction.

This Pension Protection Act made it easier for hedge funds to take pension money without registering it as an ERISA fiduciary, meaning they don't have disclosure and other requirements of other pension plan managers. Is this your field?

Ms. SCHAPIRO. This is the Department of Labor, I believe.

Senator DURBIN. Okay. Let me stop at that point and save this for the Department of Labor then.

REGULATION OF DERIVATIVES

Derivatives, contracts between two investors, betting on whether a stock, bond or other security will go up and down in value have ballooned into one of the world's largest trading markets, estimated to be tens of trillions of dollars, yet it's largely outside the regulatory umbrella. Losses, as we know, at AIG have led to a Government bailout of \$170 billion or \$180 billion.

On May 13, President Obama unveiled a plan to regulate this market which had four stated goals.

What do you consider to be the role of the SEC in this regulation?

Ms. SCHAPIRO. This is such an important area for both the SEC and the CFTC and, as you point out, the Treasury letter of May 13 lays out some requirements that we hope will be embodied in legislation with respect to credit default swaps and other standardized over-the-counter derivatives.

It will be very important to have standardized clearing mechanisms, potentially exchange trading of standardized contracts, promote transparency, have adequate margin and collateral requirements in place for these transactions and subject the dealers in these instruments to regulation.

Exactly where the lines between the SEC and the CFTC fall, I think, are something we'll be discussing certainly over the next several weeks, but it is clearly my view, and I believe Chairman Gensler's view and the Treasury's view, that we need to work together to ensure that we bring credit default swaps and other OTC derivatives firmly under the Federal regulatory umbrella and how we exactly draw those lines will be something we'll be discussing and obviously Congress will have a deep interest in, as well.

Senator DURBIN. I'll ask a question that relates to last week it was reported that two attorneys from SEC's Enforcement Division engaged in suspicious trading in stocks of companies under SEC investigation, according to a March 3 report by the SEC Inspector General David Kotz.

Mr. Kotz concluded that the SEC previously had essentially no compliance system in place to ensure that its employees did not engage in insider trading themselves. On May 22, the SEC issued a press release outlining how the agency would increase accountability.

How will this new process impact the current SEC workload? Will it require additional resources or staff to implement?

Ms. SCHAPIRO. Thank you for asking that question. It's really an important area.

When I learned about this inspector general report in March, I immediately set in motion—and some things were already underway, I should say—a number of changes to our process which was acceptable under the Office of Government Ethics rules but clearly not sufficient in my view.

We now require all trades by employees to be pre-cleared. We've created a restricted list that prohibits an employee from trading in any stock of a company that's under investigation by the SEC, whether they know anything about the investigation or its existence or not.

We prohibit any ownership in stocks of broker-dealers, investment advisors, publicly traded exchanges, and we're requiring employees to authorize that their brokers in duplicate trade confirmation statements to the SEC where they will be incorporated into a computerized system that will make monitoring compliance with all of these new rules much more effective, and we'll be hiring a chief compliance officer. I expect we'll sign the contract for the new system in the next several days and it should be operational in 1 to 3 months.

The new rules requiring pre-clearance of all trades by the Ethics Office and the creation of the prohibited list and so forth are pend-

ing at the Office of Government Ethics and have been there for about a week. We jumped on this immediately.

Senator DURBIN. Thank you very much.

Senator COLLINS.

Senator COLLINS. Thank you, Mr. Chairman.

CONSUMER PROTECTION

Ms. Schapiro, there is an idea that is being discussed to consolidate the consumer protection functions of a variety of regulators under a single entity and one such proposal would result in the SEC losing its consumer protection responsibilities.

I personally don't think this makes any sense at all because to me, the whole reason we have an SEC is to act to protect consumer investors.

What are your views on creating a single consumer protection entity that would include the SEC's responsibilities?

Ms. SCHAPIRO. I think that it certainly is one of the ideas that's being bandied about and there are many, and I think discussions continue to be very vigorous and ongoing throughout the regulatory community about the right approach here.

I think the one thing everybody agrees on is that we must have a reorientation toward consumer and investor protection among all of our financial regulatory agencies. So whether we have the creation ultimately of a single entity or we just reheighten and refocus within the bank regulatory agencies and the SEC on the protection of the end users of financial products, we, I think, all agree that we have to go down that path.

My view is that, and it's been reported that, I don't want to create new gaps in the regulatory system and I fear that moving mutual fund regulation out of the SEC and into a new agency has the potential to do that.

Mutual fund—investor protection and the mutual fund concepts, it's about more than the end product of the sale to the investor. It's really about what's the governance of the mutual fund. What's the quality of execution that the mutual fund is getting when it's buying stocks for its portfolio? What's the quality of the disclosure of those companies that the mutual fund is buying? What's the quality of the disclosure that the mutual fund itself is making?

These are all a piece. They're all woven together to create the fabric of investor protection in the mutual fund space and so I want to be sure we don't damage that fabric.

That said, whatever Congress in its wisdom and the administration working together to create that will protect investors better and consumers better, we intend to, you know, play as strong a role as we can.

Senator COLLINS. Thank you. Mr. Chairman, I'm just going to ask one final question, if I may, and that has to do with the credit rating agencies. I understand you, too, brought this issue up, but, unfortunately, I wasn't here. I was voting when you did. So I apologize if this is redundant.

I'm very concerned about the role that was played by credit rating agencies in this crisis as far as their ratings of subprime mortgages of mortgage-backed securities.

It seems to me that the current system has so many inherent conflicts of interest built into it, not the least of which is that the credit rating agencies are being paid by the firms that are marketing the securities.

What are you looking at to improve the integrity of the credit ratings process?

Ms. SCHAPIRO. You very correctly highlight that in the issuer paid model where I create a security and then I ask you to rate it and I pay you for that rating and I pay you on an ongoing basis for future ratings, if I'm happy, has profound conflicts of interest and we are looking in particular, as we discussed earlier, at the rating shopping phenomenon which allows me to select the ratings agency that provides or promises to give the highest rating and we're also looking at more robust disclosure about fees that are paid and the conflicts of interest that exist in the issuer paid model.

We held a roundtable about 1 month ago. We brought in all different kinds of rating agencies to talk about their different business models and the pros and cons of each and we've gotten a lot of very good ideas from that process and we're hoping this summer to pursue some additional rulemaking in this area.

We will focus on rating shopping. We will focus on disclosure. We will also look at whether we need to eliminate references in SEC rules which creates a market for rating agencies and gives a certain amount of credibility and stature to ratings that perhaps they don't always deserve.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Senator Tester.

Senator TESTER. Yeah. I just do want to get to the CFTC Chairman, but I just want to just close by saying thank you. Thank you for what you've done, thank you for what you're going to do.

I would ask that, you know, as these budgets come forward, 2005 to 2007 budgets were visited about here on a couple different occasions, somebody dropped the ball. Congress probably had a part to do with it. Your predecessor may have had a part to do with it.

But it ended up in a disaster and we need to make sure that you have the resources, no more, no less, but just the resources you need to do your job, and I think that, as a friend of mine pointed out last week, we need to quit thinking in Government in silos, we need to start thinking about the consumer and whoever is consuming that product, whether it's in education or housing or in this case securities, and make sure that Government works for the betterment of everybody.

But I really want to thank you for the work you've done so far. It's very impressive, and I look forward to working with you in the future.

Ms. SCHAPIRO. Thank you very much.

Senator DURBIN. Thank you very much, Senator Tester.

Chairman Schapiro, thank you for your testimony.

Ms. SCHAPIRO. Thank you, Mr. Chairman.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. We'll be working closely with you and your agency as we put together the appropriation bill.

Ms. SCHAPIRO. Thank you.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

STAYING ON THE CUTTING EDGE OF TECHNOLOGY

Question. With rapid acceleration of electronic innovations in the securities markets, the Securities and Exchange Commission faces the challenge of keeping abreast of advancements. In the face of aggressive efforts of trading firms to invest in new technology, it is critical that SEC investigators understand the nuances of modern trading operations.

Does the SEC have sufficient resources to hire the best and brightest financial technologists?

Have you identified specific gaps in SEC's workforce expertise when it comes to electronic trading?

Answer. As you may know, the SEC has launched a new initiative with existing resources to broaden the skill sets within its workforce, ranging from financial analysis to complex trading strategies. As part of this effort, the SEC is recruiting seasoned industry professionals into our enforcement, examination, and risk assessment programs, through efforts such as the Industry and Market Fellows and the Senior Specialized Examiner programs. The SEC is also implementing enhancements to the SEC's existing training programs, in areas such as the examination program which is enhancing staff expertise in topics such as fraud detection, complex financial products, and trading and where more than a third of the staff have signed up for training to become Certified Fraud Examiners. If Congress were to approve additional resources for the SEC, then the agency would look to expand these recruiting and training efforts very significantly.

A key repository at the SEC for expertise on trading systems is the Automated Review Program within the Division of Trading and Markets. The program conducts examinations of the trading systems of markets and clearing agencies, to assess the data's confidentiality, integrity, and availability. The program has been able to stay on top of this rapidly evolving field, through efforts such as the CYBER CORPS program, which has served as a great resource for identifying talented IT professionals, and through the NSA, which has provided non-commercial software and technical training. Over the past few years, the program has increased its expertise in IT security and launched new initiatives in the areas of cyber security, auditing intermediaries in credit default swaps, and international markets. The Division now plans to implement new source code review of trading systems and more sophisticated penetration testing, to the extent resources are available.

EXPEDITING FAIR FUNDS DISBURSEMENTS

Question. Under the "Fair Funds for Investors" provision (Section 308(a) of Sarbanes-Oxley), the Securities and Exchange Commission is required to return money to investors victimized by securities fraud. Previously, disgorgements and penalties were deposited into a U.S. Treasury General Fund.

Answer. The Fair Funds provisions of the Sarbanes-Oxley Act of 2002 gave the Commission authority to increase the amount of money returned to injured investors by allowing civil penalties to be included in Fair Fund distributions. Prior to Sarbanes-Oxley, only disgorgement could be returned to investors.

Question. What improvements have been realized so far from the creation of a specialized office on "Fair Funds" disbursement?

Answer. The Commission established the Office of Collections and Distributions (OCD) to, among other things, expedite the distribution of Commission recoveries to injured investors. The Office is responsible for overseeing the distribution of funds to investors who have been injured by securities law violations, implementing the Enforcement Division's collections and distributions programs, and conducting litigation to collect disgorgement and penalties imposed in certain Enforcement actions. In addition, the Office tracks, records, and provides financial management assistance with respect to the funds and provides overall case management services for the Division.

The Office has helped streamline the distributions process and enhance its internal controls, and it has overseen the distribution of approximately \$3.2 billion to injured investors to date. Among the Office's recent initiatives has been to issue standardized, step-by-step guidance to enforcement staff on developing and imple-

menting distribution plans in both civil actions and administrative proceedings. In addition, the Office has consolidated collections and distributions information onto the enforcement program's internal website so that is more accessible to staff nationwide. In collaboration with other SEC offices, OCD has created templates to standardize the reporting of periodic and final accountings for distributions of disgorgement funds and Fair Funds, as well as to facilitate the examination of administrative expenses. In order to manage receivership expenses, the Office also developed billing instructions for receivers. OCD conducts training for the staff on the use of both the standardized reports and the billing instructions.

Question. SEC's financial tracking system (Phoenix) was established to improve management of distribution of Fair Funds to victims of securities law violations. Is the "Phoenix" system fully functional at this time? What remains to be done to improve its capabilities?

Answer. To date, the Phoenix system has only been partially deployed. Under the functionalities that are already operational, Phoenix assists with tracking and recording the disgorgement and penalties ordered in Enforcement actions. However, the Phoenix system does not yet track and record distribution information. This function is currently performed in a limited way within CATS 2000, the SEC's case tracking system, which is itself slated to be replaced.

To that end, the agency is developing business requirements for a new module that would record and monitor distribution-related information, including information reported on the newly developed standardized accounting reports. Once fully built, this module would enable the SEC to track a distribution fund's current status or phase in the distribution process, enhance reporting and internal controls over the accuracy and integrity of distribution data, and provide better information about the investment of Commission funds with the Department of the Treasury's Bureau of Public Debt. This effort also will support integration with the agency's core financial management system.

The SEC expects to finalize and deploy the distributions module in fiscal year 2010, depending on the availability of sufficient funding.

Question. I note that SEC is currently reviewing its performance measure of the percentage of Fair Funds and disgorgement dollars designated for distribution to victims within a year. What are the challenges? What is hampering SEC's ability to track the timeliness of the fund distributions and maintain accurate data?

Answer. As noted in the Commission's fiscal year 2010 budget justification, this measure is currently under review and may be adjusted in the future. One of the primary challenges with respect to such a measure has been the SEC's inadequate systems to collect, analyze, and report on distributions (described above), which have hampered the Commission's ability to track the timeliness of the fund distributions and maintain accurate data.

Question. What portion of this year's budget (fiscal year 2009) and the proposed needs for fiscal year 2010 will be devoted to the Fair Funds distribution project?

Answer. The first major expense associated with Fair Funds distributions is information technology, most notably the Phoenix system. In fiscal year 2009, the SEC expects to obligate approximately \$0.1 million in ongoing maintenance and support related to Phoenix. For fiscal year 2010, the agency estimates that distributions-related projects will cost approximately \$3.2 million. These projects include efforts to develop new collections and distributions tracking functionalities, enhance the current Phoenix system, integrate Phoenix with the enforcement program's new HUB tracking system and the core financial system, and conduct ongoing system maintenance.

A second component of the SEC's distributions-related costs is the expense associated with the Office of Collections and Distributions. OCD's costs amount to approximately \$6.0 million in fiscal year 2009 and \$6.2 million in fiscal year 2010. However, it is important to note that the Office performs a variety of functions in addition to distributions, including assisting with collection of delinquent debts and maintenance of internal controls.

The final element is the substantial staff time spent on distributions functions within other parts of the SEC. For example, within the enforcement program (outside of OCD), attorneys spend considerable time on the development, oversight, and implementation of distribution plan actions, while support staff perform data input for all cases. In addition, the SEC's Office of Financial Management aids with funds investment and disbursement, as well as internal controls; the Office of the General Counsel reviews and comments on distribution-related documents; and the Office of Economic Analysis evaluates the methodologies for measuring investor loss. Although the staff time involved is significant, the SEC does not currently track costs at this level.

QUESTION SUBMITTED BY SENATOR BEN NELSON

RULE 151A, ISSUED JANUARY 16, 2009

Question. On January 16th of this year, the Commission issued a new rule regarding indexed annuities and certain other insurance contracts. This rule takes effect on January 12, 2011.

What level of resources will the SEC devote in fiscal year 2010 to preparing to implement this rule? Can you calculate the cost to the Commission of the work necessary to fully implement this rule so that it can be operational on January 12, 2011?

Looking ahead to the next fiscal year (fiscal year 2011), in taking on this additional regulatory responsibility, will additional staff be required? What will additional staff needs and additional regulatory responsibility mean for the Commission's budget?

Answer. The release adopting this rule (Rule 151A) articulated the Commission's determination that investors in certain indexed annuity contracts are entitled to the protections of the federal securities laws. The rule includes a new definition of "annuity contract" that, on a prospective basis, will define a class of indexed annuities that are outside the scope of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities will, on a prospective basis, be required to register under the Securities Act. With few exceptions, indexed annuities historically have not been registered as securities. The new definition will apply to indexed annuities that are issued on or after the January 12, 2011, the effective date of the rule.

The staff is currently considering how to tailor disclosure requirements for indexed annuities. As with any other rulemaking, if the staff determines to recommend that the Commission propose new disclosure requirements, resources will be applied to develop a proposal, analyze public comments on the proposal, determine whether to recommend adoption of the proposal and consider whether and how it should be modified to reflect commenters' concerns.

In addition, the Commission encouraged insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance regarding the implementation of the rule. We anticipate that any responses to such requests will require staff resources.

The Division of Investment Management also anticipates reviewing filings for approximately 400 new indexed annuity contracts in the first year.

In all, the Division of Investment Management believes the implementation of Rule 151A will require an allocation of seven staff positions during the first year, with that number likely to decrease in the years following the initial implementation. The estimated cost of these seven positions is \$1.6 million for fiscal year 2011. As discussed above, these staff will perform further rulemaking as appropriate, provide interpretive advice, and review disclosure filings.

QUESTIONS SUBMITTED BY SENATOR SUSAN COLLINS

Question. Chairman Schapiro, recently many news outlets have issued stories about the administration's proposal to move some consumer-protection powers outside of the SEC. Reports state that you are opposed to such a proposal. A May 20th Wall Street Journal article quotes you as saying that such a plan would ". . . be hugely expensive and highly inefficient . . ." Would you discuss your objections?

Answer. I did not believe that investors would be better protected by separating some securities products from others, potentially creating gaps in the regulatory and enforcement regime. Securities products are different from consumer credit products: generally they are not guaranteed and include a number of inherent risks, including the loss of principal. The administration's white paper outlining its consumer protection plan appears to recognize this, and I do not object to that approach.

Question. Secretary Geithner recently laid out a framework for overseeing the derivatives market including rigorous reporting requirements. Such a proposal would give the SEC and CFTC new authorities to regulate derivatives. What are your thoughts on the plan and the role of the SEC in the regulation of derivatives?

Answer. I agree with the Secretary's approach. Both the SEC and CFTC have a role in regulating derivatives products. We continue to work together and make progress on how such a regime might work to best fill gaps in the regulatory framework and prevent regulatory arbitrage. I look forward to working with Congress to make the necessary legislative changes.

Question. Two veteran enforcement lawyers at the SEC are currently under investigation for insider trading. A May 16 Wall Street Journal article quotes a report by the SEC Inspector General saying that “the SEC has ‘essentially no compliance system’ to detect potential insider trading.” As a result of the investigation into the trading activities of the two attorneys, the SEC has proposed the imposition of new rules on employee trades. How does this investigation affect your confidence in the ability of the SEC staff? In your estimation, do the recent troubles at the SEC signify fundamental problems within the organization, and if so how do you propose to rectify the issues?

Answer. I have the utmost confidence in the ability of the SEC’s staff and their unflagging dedication to the protection of investors. Time and time again, I have been impressed by the staff’s talent, integrity, and enthusiasm for the agency’s mission. However, it became clear to me soon after joining the agency that the SEC’s system for ensuring compliance with employee trading rules was not sufficient. The report by the agency’s Inspector General concerning trading activity by certain employees reinforced my belief that the SEC should have a trading compliance system that is second to none.

I know the agency’s staff shares my belief that, in light of the SEC’s mission, it is vital that we conduct ourselves according to the highest standards of ethical conduct when it comes to our own financial holdings and transactions. To that end, we have taken several significant steps to strengthen the SEC’s compliance system and reduce the potential for even the appearance of inappropriate securities trading:

- We have proposed new rules concerning employee trading. These rules will, among other things:
 - Require the pre-clearance of all trades.
 - Prohibit all trading in the securities of a company under SEC investigation, regardless of whether the employee is aware of the investigation.
 - Require all employees to authorize their brokers to provide duplicate trade confirmation statements to the agency.
 - Prohibit the ownership of securities in publicly-traded exchanges and transfer agents, in addition to existing prohibitions against owning securities in other firms directly regulated by the Commission.
 - Require employees to certify that they do not have any non-public information about the company whose securities they are trading.
- These rules were submitted to the Office of Government Ethics (“OGE”) on May 22, 2009, and we await OGE’s comments.
- We recently retained an outside firm specializing in automated compliance systems to develop a new computer compliance system for the agency, which will automate and simplify the transaction reporting process and make it easier to verify and monitor employee trading.
- We are creating a new Chief Compliance Officer position, and have already received applications from a number of excellent candidates for the new position.
- I have consolidated responsibility for the oversight of employee securities transactions within the SEC’s Ethics Office and devoted additional staff resources to monitor, review, and spot-check these transactions.

These measures will bolster and modernize the agency’s compliance program, and help the talented and committed staff do its critical work of protecting investors without distraction.

Question. The fiscal year 2010 budget request does not include an increase for the SEC Inspector General. Considering the likelihood of an increased workload at the IG’s office, as the SEC increases surveillance and monitoring of employee trading, do you think that the IG will need additional funds?

Answer. The Inspector General submitted a request for three additional positions only a few days before the publication of the SEC’s Congressional Justification for fiscal year 2010, and therefore these additional positions were not reflected in the document. However, I have since approved the addition of these personnel, which would bring the OIG to a total of 19 positions. When these new staff are combined with the two positions approved for OIG in January 2009, the Office will have grown by a total of 73 percent within this calendar year, which is the highest growth rates of any SEC office during this timeframe.

Question. Please provide a breakdown of the tips and complaints the SEC received in fiscal year 2007 and fiscal year 2008, to help explain the large decline in that year.

Answer. As you mentioned, the number of tips and complaints received by the SEC’s Office of Internet Enforcement declined significantly between 2007 and 2008, from about 1,586,000 to about 615,000 in 2008. Unfortunately, the SEC has not had a tracking system that can break down those figures into their component parts or support rigorous analysis of underlying trends.

The SEC's initiative to bolster its systems for tracking tips and complaints, working with the Center for Enterprise Modernization, will help the agency perform much better analyses in the future. Such analyses will help the SEC understand the overall statistics on tips and complaints and identify trends among specific firms or practices that can provide valuable information for potential enforcement action and compliance exams. The SEC also is working to streamline and standardize the agency's handling of tips and complaints, so they can be addressed more consistently and effectively. Nevertheless, for the 2007–2008 period, the SEC is reliant on anecdotal evidence to explain the decline in tips and complaints during that timeframe.

In general, the number of complaints the agency sees is related to the volume of spam and commercial email traffic received by investors. A number of factors likely affected this volume during the 2007–2008 timeframe. First, the SEC's initiative starting in 2007 to combat spam-driven stock manipulations was reported to have been a major contributor to reducing the amount of spam.¹ Under this initiative, the SEC suspended trading in the securities of dozens of companies that had been the subject of spam stock promotions and initiated several spam-related enforcement actions. According to a private-sector Internet security report, a 30 percent decrease in stock market spam "was triggered by actions taken by the U.S. Securities and Exchange Commission, which limited the profitability of this type of spam . . ."²

Another major factor is the growing use and sophistication of commercial-grade spam email filters, blacklists, and experimental "data mines," which radically diminish the number of mass investment solicitations received by the average investor. Additionally, tough state and federal anti-spam laws, and high-profile prosecutions under those laws, likely helped to deter spammers.³

General market conditions also likely played a role in the decline in tips and complaints. Email stock promoters' activities lend themselves best to the promotion of obscure, thinly-traded stocks, such as the tech stocks that flourished during the late 1990s market "bubble." Since the collapse of that bubble, it seems fewer investors have been interested in these microcap stock promotions.

It is important to note that, while the number of tips and complaints went down significantly in 2008, the figure is still 146 percent higher than it was 5 years previously. By comparison, the number of full-time equivalents in the SEC's enforcement program increased by only 23 percent during that period. Also, while the quantity of complaints the SEC received decreased between 2007 and 2008, the SEC believes that the quality of complaints has increased dramatically. Thus, the agency's workload from these complaints has actually become greater over the past year, despite the reduced number of complaints relating to spam.

ADDITIONAL SUBMITTED STATEMENT

[CLERK'S NOTE.—The subcommittee has received a statement from the Investment Company Institute which will be inserted into the record at this point.]

¹"SEC makes inroads against financial spam; Crackdown pays off as e-mail campaigns slow," by Matt Krantz, USA Today, Oct. 5, 2007 at p. 7A.

²http://eval.symantec.com/mktginfo/enterprise/white_papers/enterprise-whitepaper_internet_security_threat_report_xii_09_2007.en-us.pdf. Copyright 2007 Symantec Corporation. All rights reserved. Symantec, the Symantec Logo, BugTraq, Symantec Brightmail AntiSpam, and Symantec DeepSight are trademarks or registered trademarks of Symantec Corporation or its affiliates in the United States and other countries. Apple, Mac OS, and QuickTime are trademarks of Apple Inc., registered in the United States and other countries. Safari is a trademark of Apple Inc. Microsoft, ActiveX, Windows, and Windows Media are either registered trademarks or trademarks of Microsoft Corporation in the United States and/or other countries. Sun, Java, and Solaris are trademarks or registered trademarks of Sun Microsystems, Inc. in the United States and other countries.

³See http://www.msnbc.msn.com/id/18955115/arrest_of_Robert_Alan_Soloway; <http://www.sophos.com/pressoffice/news/articles/2008/02/japan-spam.html> (Yuki Shiina); http://spamkings.oreilly.com/archives/2006/03/stock_spammers_stung_by_secret.html ("g00dfellas" spam gang).

PREPARED STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute¹ appreciates this opportunity to submit testimony to the Subcommittee in support of the administration's fiscal year 2010 appropriations request for the Securities and Exchange Commission (SEC). We commend the subcommittee for its consistent past efforts to assure adequate resources for the SEC. For the reasons expressed below, we urge Congress to provide appropriations at least at the funding level requested by the President.

As SEC Chairman Mary Schapiro noted in her testimony, the recent financial crisis has served as a reminder of the importance and interconnectedness of the securities markets to our nation's economy and the financial health of millions of Americans. The crisis also demonstrated that the current regulatory system is not up to the challenges posed by modern financial markets and needs to be significantly strengthened and modernized. It has led to broad support for reform of the U.S. system of financial services regulation, including numerous calls for Congress to close regulatory and disclosure gaps to ensure appropriate oversight with regard to hedge funds, derivatives, and municipal securities. Toward these ends, it is critically important to provide the SEC with the resources necessary to assure its ability to soundly and effectively regulate securities offerings, market participants, and the markets themselves. And, to the extent that the scope of the agency's responsibilities is expanded with respect to hedge funds, derivatives, and/or municipal securities, it will be imperative that it have sufficient staffing and resources to effectively perform all of its oversight functions.

More generally, the ongoing policy discussions about regulatory reform have highlighted why adequate funding for the SEC should continue to be a Congressional priority. Unlike other financial regulators, the SEC is specifically charged with protecting investors. The agency seeks to fulfill this mission in many different ways, including through the disclosure and substantive rules it adopts and administers, through examinations of regulated entities, and through its enforcement program, to name a few. In the wake of the financial crisis, it is essential to provide the SEC with the resources it needs to successfully pursue its investor protection mission.

Mutual funds and other registered investment companies have a strong stake and vested interest in having a well-funded and effective SEC. Registered investment companies are an integral part of our economy. They represent, as a whole, the largest group of investors in U.S. companies, holding 27 percent of the outstanding stock in U.S. companies at year-end 2008. Registered investment companies also held the largest share of U.S. commercial paper—an important source of short-term funding for major U.S. and foreign corporations. In addition, they continue to be one of America's primary savings and investment vehicles for middle-income Americans. Today, over 93 million investors in more than 53 million U.S. households own shares of registered investment companies; the median household income of these investors is \$80,000. And, since 1990, the percentage of U.S. retirement assets held in mutual funds and other registered investment companies has more than quadrupled. These millions of Americans continue to recognize that mutual funds are the best means of achieving their long-term financial goals. They deserve and benefit from continued vigilant regulatory oversight of mutual funds and other registered investment companies.

The administration's fiscal year 2010 budget proposes SEC funding at a level that represents a 7 percent increase over fiscal year 2009. Chairman Schapiro explained in her testimony that this would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance its ability to uncover and prosecute fraud, and allow it to begin to build desperately needed technology. More specifically, Chairman Schapiro stated that the additional funding would allow the SEC to hire seasoned industry professionals and market experts to strengthen and expand the SEC's Office of Risk Assessment, improve its examination program, and bolster its oversight of the investment management and broker-dealer industries. We have strongly supported precisely these types of measures.² It is essential that the agency

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$10.18 trillion and serve over 93 million shareholders.

² See Letter to The Hon. Mary L. Schapiro from Paul Schott Stevens dated February 18, 2009 (attaching recommendations for SEC priorities under Chairman Schapiro's leadership). See also *Financial Services Regulatory Reform: Discussion and Recommendations*, which is available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf. Chairman Schapiro also noted in her testimony that she intends to improve the overall management of the SEC, including by hiring a Chief

have greater ability (and resources) to attract and retain professional staff having significant prior industry experience. Their practical perspectives would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy. The new Industry and Market Fellows Program is an encouraging step in the right direction, but we also believe that the agency should build strong economic research and analytical capabilities and should consider having economists resident in each division.

We are particularly pleased that a key strategic priority for the SEC's Division of Investment Management will be to strengthen and improve the money market fund regulatory regime. Last November, we convened a high level industry working group to study the money markets. In March, the group made a series of comprehensive recommendations that responded directly to weaknesses in current money market fund regulation, identified additional reforms that will improve the safety and oversight of money market funds and position responsible government agencies to oversee the orderly functioning of the money market more effectively.³ We look forward to working with the SEC on this critically important issue.

In conclusion, the SEC and the fund industry share a common objective of assuring that mutual funds remain a vibrant, competitive and cost effective way for average Americans to access the securities markets and realize their long-term financial goals. Future regulatory and oversight actions by the SEC will play a key part in this process. It is therefore critically important that the SEC have sufficient resources to adequately fund the staffing of the agency and to take other steps to fulfill its mission of protecting the nation's investors, including the over 93 million Americans who own mutual funds. Accordingly, we urge Congress to provide appropriations at least at the funding level requested by the President.

We appreciate your consideration of our views.

Operating Officer to manage the organization. We also supported this idea in both our February 18, 2009 letter to Chairman Schapiro and *Financial Services Regulatory Reform* white paper.

³ See *Report of the Money Market Working Group*, submitted to the Board of Governors of the Investment Company Institute on March 17, 2009, available at http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. GARY GENSLER, CHAIRMAN

Senator DURBIN. I'd like to invite Chairman Gensler from the Commodity Futures Trading Commission to come forward.

This year, 2009, marks the 35th year since the establishment of this agency. At this time of its inception in 1974, CFTC's 500 employees were tasked with ensuring fair practices and honest dealings on the commodity exchanges of America's then \$500 billion industry in 1974.

Today, it is a \$22 trillion industry and it looks a lot different. The traditional agricultural products are still there, but the landscape has been diversified with novel and complex commodities, from grains to gold, currencies to carbon credits.

In the past decade trading volume has increased more than tenfold, reaching over 3.4 billion trades in 2008. Actively traded contracts have quintupled from 286 in 1998 to 1,521 in 2008.

CFTC oversees \$5 trillion of trades every single day. So we don't want you to stay at the table too long. We want you to get back and keep an eye on those trades, but we invite you, Chairman Gensler, to give your testimony at this point.

Mr. GENSLER. Thank you, Chairman Durbin, Ranking Member Collins, and members of the subcommittee, Senator Tester.

I'm pleased to be here today to discuss our budget and especially pleased to learn that Senator Durbin recently visited our Chicago office which very encouraged the staff and I thank you for it.

I'm also grateful to each of you for your individual support on my recent confirmation. It's an honor to serve the country in this capacity.

I come before you having served as Chairman just 6 calendar days, but with full knowledge of the failures of our regulatory system, failures that affected all Americans, failures that we must ensure do not happen again, and as Chairman, I will use every authority available to protect the American people from fraud, manipulation, and excessive speculation.

I will also work with Congress on new authorities to bring much-needed transparency and regulation to the over-the-counter derivatives marketplace.

I am grateful on behalf of the agency for the \$146 million recently appropriated for this Commission. This boost has allowed us to get back to beginning to address the alarmingly low staffing levels there are at the agency. Our size, however, is still roughly equivalent to the Commission that was established 35 years ago.

Today, the futures market is dramatically different, as Chairman Durbin just outlined, being some 45 times larger than it was 35 years ago, and much more complex as well.

Just 10 years ago the CFTC was near its peak staffing levels, near 580 full-time equivalents. It's shrunk over 20 percent in the

past years, but with your help the fiscal 2009 funding will permit us to get back to where we were in 1999.

Since 1999, however, volumes have gone up fivefold, the number of contracts have gone up sixfold. The complexity, of course, I don't need to tell you, has gone up dramatically. We've gone from open outcry pits to electronic trading which is in some cases harder to monitor. We've also lived through the worst financial crisis in 80 years and seen the results of an asset bubble in commodity prices.

In short, the Commission remains an underfunded agency and we're very grateful to the President's budget of \$160.6 million in recognition of some of these needs. If I could just share with you some of the things that have been highlighted to me in my first 6 days. I think we still need to ensure that our enforcement effort is larger to ensure robust enforcement of our laws. Currently, we have about 141 attorneys in our Enforcement Division. I believe this is still quite lower than what's required, given the financial turmoil we've lived through.

We must ensure greater transparency. I believe that commodity index funds did contribute to the asset bubble that we've just lived through. To bring greater transparency will require more economists. It's going to require announcements in our weekly commitments in traders' reports. We'll also need to upgrade our systems as well.

We must ensure that position limits consistently applying across the board, and that we're reviewing hedge exemptions and no action processes in that regard.

Our information technology (IT) systems and particularly our mission critical systems on positions and transactions have not been upgraded for quite some time and I've looked forward to working with this subcommittee on getting funds to try to upgrade these mission critical systems.

And also, we need to ensure timely review of new products and rule change filings. This has lagged a great deal and just last year with the new farm bill, the review of significant price discovery contracts will be important moving forward.

These are only a few of the funding priorities, but I wanted to give the subcommittee a tangible sense of some of the things that we're grappling with and struggling with.

With that in context, the \$14.6 million of additional funding, about one-half of that is to stay at current services and one-half of that in the President's budget, fortunately, is for 38 new full-time equivalents to bring us back just above where we were 10 years ago, to about 610 full-time equivalents. These positions are essential. The increase, however, still won't allow us to fully address these complex markets and what we need to do.

Before I close, I would like to highlight that the additional funding needs will also accompany much-needed regulatory reform. I, along with other regulators, and the administration feel we need to broaden reforms in the over-the-counter derivatives marketplace and bring it all under the regulatory umbrella. I look forward to working with this subcommittee and Congress for funding those new authorities to make sure they're properly implemented.

PREPARED STATEMENT

And with that, I thank you very much and I look forward to answering your questions.

I hope my written testimony can be entered into the record.

Senator DURBIN. Of course. It will be.

[The statement follows:]

PREPARED STATEMENT OF GARY GENSLER

Thank you, Chairman Durbin, Ranking Member Collins, and other members of the Subcommittee. I am pleased to be here to testify on behalf of the Commodity Futures Trading Commission, and I appreciate the opportunity to discuss issues related to the Commission's 2010 Budget. I am also grateful to have had each of your individual support for my recent confirmation. It is a great honor to serve my country in this capacity.

I come before you today having only served as CFTC Chairman for 6 calendar days, but with the full knowledge of the failures of our financial regulatory system; failures that affected all Americans and failures that we must ensure never occur again.

The last decade, and particularly the last 21 months, has taught us much about the new realities of our financial markets. We have learned the limits of foresight and the need for candor about the risks we face. We have learned that transparency and accountability are essential and that only through strong, intelligent regulation can we fully protect the American people and keep our economy strong.

As Chairman of the CFTC, I will use every tool and authority available to protect the American people from fraud, manipulation and excessive speculation. I also look forward to working with Congress to establish new authorities to close the gaps in our laws and bring much-needed transparency and regulation to the over-the-counter derivatives market. I firmly believe that doing so will strengthen market integrity, lower risks, protect investors, promote transparency and begin to repair shattered confidence in our financial markets.

I would like to thank the Committee for the \$146 million recently appropriated for the CFTC for the 2009 fiscal year and special thanks to Chairman Durbin for visiting our Chicago office last year. As a result of this much needed boost in funding, the Commission has begun to address our alarming staffing levels; levels that recently reached historic lows.

At present, the Commission employs about 500 career staff—roughly equivalent to when the Commission was created in 1975. Three decades later, the futures market has changed in every way: with respect to volume, complexity, risk and locality. What was once a group of regional domestic markets trading a few hours 5 days a week is now a global market trading 24/7, and what was once just a \$500 billion business has exploded to a \$22 trillion annual industry.

Ten years ago, the CFTC was near its peak staffing level at 567 employees, but shrunk by 20 percent over the subsequent 8 years before hitting a historic low of 437.

With the increase in fiscal year 2009 funding the CFTC can reach 572 employees.

While this is a start, I believe that merely raising our staffing levels to the same as a decade ago will not be enough to adequately fulfill all of the agency's missions. In the last 10 years, trading volume went up over five fold. The number of actively traded futures and options contracts went up over six fold, and many of these are considerably more complex in nature. We also moved from an environment with open-outcry pit trading to highly sophisticated electronic markets.

In addition to the dramatic evolution of the futures industry, we have experienced the worst financial crisis in 80 years. We also experienced, in my view, an asset bubble in commodity prices. The staff of the CFTC is a talented and dedicated group of public servants, but the significant increase in trade volume and market complexity, as well as rapid globalization, commands additional resources to effectively protect American taxpayers.

For all of these reasons, I feel it is appropriate for our staffing levels and our technology to be further bolstered to more closely match the new financial realities of the day.

In short, despite the recent increase in funding, the Commission remains an underfunded agency. The President's Budget recommendation of \$160.6 million is recognition of this need. Specifically, the Commission needs more resources to hire and retain professional staff and develop and maintain technological capabilities as sophisticated as the markets we regulate.

I'd like to identify some of my priorities and provide some illustrations of how resource limitations have constrained the Commission. Among my priorities will be to:

- Ensure robust enforcement of our laws. Currently, the Commission's enforcement program consists of 122 employees—the lowest level since 1984. Though fiscal year 2009 funding will get us back to 141 enforcement employees, this is still below the agency's peak of 167 and well below what we need given the current financial turmoil. Any financial downturn reveals schemes that could only stay afloat during periods of rising asset values. Our current, and much larger, downturn is exposing more leads than the Commission can thoroughly and effectively investigate. This is true both as it relates to fraud and Ponzi schemes as well as staff intensive manipulation investigations. The regulations we enact to protect the American people are meaningless if we do not have the resources to enforce them;
- Ensure greater transparency of the marketplace. Also, I believe that commodity index funds and other financial investors participated in the commodity asset bubble. Notably, though, no reliable data about the size or effect of these influential investor groups has been readily accessible to market participants. The CFTC could promote greater transparency and market integrity by providing further breakdowns of non-commercial open interests on weekly "Commitments of Traders" reports. The American public deserves a better depiction of the marketplace. The temporary relief from higher prices does not negate this need, especially given that a rebounding of the overall economy could lead to higher commodity prices;
- Ensure position limits are consistently applied. The CFTC has begun a review of all outstanding hedge exemptions to position limits. This review will consider the appropriateness of these exemptions and look for ways to institute regular review and increased reporting by exemption-holders. The Commission also has begun a review of the process and standards through which no-action letters are issued. As part of these reviews, CFTC staff will consider the extent to which swap dealers should continue to be granted exemptions from position limits;
- Ensure the Commission has the tools to fully monitor the markets. We must upgrade the Commission's mission critical IT systems for the surveillance of positions and trading practices. Neither is robust enough nor have they been upgraded to reflect the vast increase in volume and complexity. Our systems must begin to produce the surveillance reports needed to meet the analytical needs of our professional staff and the transparency needs of the public; and finally
- Ensure timely reviews of the many new products and rule change filings of the futures markets. These have lagged due to the growth and complexity of markets and the added responsibilities extended to the Commission in the 2008 Farm Bill. The Farm Bill requires staff to review all contracts listed on Exempt Commercial Markets (ECMs) to determine if they are significant price discovery contracts—if they are, then any ECM that lists such a contract must also be reviewed to determine compliance with a stringent set of core principles under the Commodity Exchange Act.

Other examples that I believe are illustrative of the difficult tradeoffs caused by resource constraints are:

- The Commission does not conduct annual compliance audits of every Designated Contract Market (DCM)—rather only periodic reviews on average, every 3 years;
- The Commission does not conduct annual compliance audits of every Derivatives Clearing Organization (DCO)—rather periodic reviews are conducted of selected core principles that are rotated and completed every 3 years; and
- The Commission does not conduct routine examinations of Commodity Pool Operators, Commodity Trade Advisors, and Futures Commission Merchants—a function currently performed by Self Regulatory Organizations. If the Commission were to perform direct periodic audits our staff would better understand the operations of brokers and managed funds and could better assess compliance with the law and regulations.

These are only a few of our important funding priorities and the workload challenges imposed by resource limitations. There are, of course, others. I hope that this helps the Committee to understand, in a tangible way, the challenges the Commission faces in regulating the futures markets the way the Nation requires.

Although the work of the Commission can be highly technical in nature, the mission of the agency is quite straightforward. The CFTC is charged with:

- Protecting the public and market users from manipulation, fraud, and abusive practices and
- Promoting open, competitive and financially sound futures markets.

With that context, I would like to address the specifics of the fiscal year 2010 Budget request. The fiscal year 2010 Budget proposes an increase of \$14.6 million. Approximately half of the increase is needed to maintain our fiscal year 2009 level of operations into fiscal year 2010. The balance would fund an additional 38 positions.

Twenty-six of the 38 staff would be allocated to principal program areas. Specifically, we would allocate 11 positions to Enforcement, 8 to Market Oversight, 6 to Clearing and Intermediary Oversight, and 1 to the Chief Economist's office. The remaining 12 positions will provide critical mission support in the areas of legal analysis and counsel, technology support, international coordination, legislative and public outreach, and human capital and management support.

The additional 38 positions are essential to addressing some of the limitations I mentioned earlier. This increase, however, will not provide the Commission with the critical mass of professional and technical expertise needed to ensure that the growing markets remain free of manipulation and fraud.

For example, our enforcement staff needs to be significantly expanded to:

- Ensure that crimes are punished to the fullest extent of the law;
- Develop strategies aimed at quickly identifying and eradicating fraudulent schemes, such as Ponzi and foreign exchange “boiler rooms”; and
- Importantly, pursue resource-intensive investigations and litigations involving manipulation, including energy-related market abuses, so wrongdoers will not believe they are immune from enforcement simply due to the complexity of an enforcement action.

Insufficient resources in the enforcement division force it to be too selective in the matters it investigates.

Our market oversight operation needs additional highly-skilled economists, investigators, attorneys and statisticians to:

- Analyze trading reports quickly and thoroughly, identify potential market problems or trader violations promptly, and avoid market disruptions and pricing anomalies;
- Conduct timely and complete reviews of regulated entities to ensure compliance with all core principles;
- Examine exchange self-regulatory programs on an on-going and routine basis with regard to trade practice and market surveillance; and
- Ensure their compliance with disciplinary, audit trail, record-keeping and governance obligations.

Our clearing and intermediary oversight program needs additional auditors, analysts, and attorneys. This would allow us to:

- Ensure clearing systems protect against a single market becoming a systemic crisis;
- Protect investors' funds from being misused or exposed to inappropriate risks of loss; and
- Guard against abusive sales practices that harm customers and undermine market integrity.

Our economic research program needs more economists to review and analyze new market structures and off-exchange derivative instruments, especially in light of novel and complex products and practices that call for state-of-the-art economic analysis. Further, additional resources would enhance our economic and statistical analysis, improving transparency of markets and better supporting the Commission's enforcement and surveillance programs.

We also need to transform the current legacy information technology systems into robust systems capable of efficiently receiving and managing massive amounts of raw data as well as transforming them into useful analytical and research tools.

The Commission has made a substantial investment in technology over the past 2 years—focusing first on upgrading obsolete computer hardware to industry standards. We need technology, however, that is as modern and dynamic as the technology-driven markets we are charged with overseeing. Our investment in technology must be more than just periodic equipment upgrades and maintenance. The Commission must leverage resources by employing 21st century technology to protect the American people.

As the Commission informed this Committee in February of this year, the agency believes it needs \$177.7 million for fiscal year 2010 to perform its present duties. I look forward to working with this Committee to secure the funding necessary to meet our current regulatory responsibilities.

Before I close, I would like to briefly highlight funding needs that might go along with much needed regulatory reform. The CFTC along with the administration and other financial regulators is committed to working with Congress on broad regu-

latory reform. This is particularly true for the markets that the CFTC currently regulates and the markets that may soon come under our regulation.

Specifically, we must urgently regulate the over-the-counter derivatives market and address excessive speculation through aggregated position limits.

President Obama has called for action by the end of this year to strengthen market integrity, lower risks, and protect investors. The future of the economy and the welfare of the American people depend on a vibrant Commission to assist in leading the regulatory reform ahead. Additional funding will be necessary to properly implement these reforms.

I look forward to working with the Members here today and others in Congress to accomplish this goal.

Thank you very much. I would be happy answer any questions you may have.

STAFFING

Senator DURBIN. Chairman Gensler, thank you for being here and we're glad that you're on the job, and it strikes me that if we look at your recent arrival and the recent arrival of a lot of money into your agency, that you're really going to be tested quickly in terms of whether or not you can gather together the professional staff to do your job and the added responsibilities that you mentioned in the farm bill. I don't know if you have had a chance to look at the inspector general's report on your agency but that was, I think, one of the major points made by that report, as to whether or not you would have the human capital necessary to monitor the complex situations that you face.

Now, there's been some problems in the past at CFTC when it comes to Federal pay parity, where the Government basically said let's start treating all the professionals in our agencies alike and CFTC seemed to be lagging in the past in bringing the income levels up to meet the pay parity standard.

You mentioned my visit to the office in Chicago and I'm glad I did it. I don't know how many other Congressmen or Senators have been there, but it's an eye-opener. It's a small staff but it's an amazing staff and I was very impressed. There are some people we have working for our Government in that office who do such exceptional work.

One man they introduced me to, I've forgotten his name unfortunately, and they told me what his responsibility was each day and they said he is the go-to guy. He watches all of these transactions going and he's the one who monitors them and if he weren't here, you know, I'm not sure how good a job we'd do. It would take a lot more people to try to do what he does every day. I said, "Does this man take a vacation?" They said, "Yes, he does and we try to hang on until he gets back."

It's that kind of person and that kind of responsibility which leads me to ask, now that we've sent you a substantial amount of money in this year's fiscal year bill, in the omnibus bill, and now that we've told you you need more professional people and now that you're looking at this pay parity issue, how are you trying to fit these pieces together into some coherent way of expanding your agency in a manner that is consistent with rewarding the good performance of people there and bringing onboard the kind of folks that you need to meet these new electronic markets?

Mr. GENSLER. Senator, I think you're right in these are important challenges. Just being in the job for 6 days, what I see are talented staff facing significant challenges ahead.

Senator DURBIN. Incidentally, you're new to this, but it's always great to start your answer with Senator, you're right. Please proceed.

Mr. GENSLER. Senator, you're right. As I understand it, the agency's been able to fulfill all of the job postings—about 95 job postings. There's confidence, at least within the staff, as to what might be achieved by September 30. We all know there's a summer and August and so forth, but all the postings are up. Some of the recruiting has already occurred and people have been coming in.

But I also agree with Chairman Durbin that this agency, which was so sorely underfunded and actually shrank over 20 percent in the face of this complexity during the last 8 years, has too many jobs that are being done by one person or not enough. As an example, when I asked, well, how large is the group that oversees clearing, this really important function in futures. I was told that there is a nine-person staff out in Chicago, which is part of that larger staff, I said, "Is that enough?" Well, you know, everybody said, "Well, that's what we have. We've had to make tough choices."

So I think that's very important. I'm committed to make sure that taxpayer dollars are put to work most appropriately and efficiently, but I do have confidence in what I've seen in 6 days, that there's a plan of action for these hires.

Senator DURBIN. What about the pay parity issue?

Mr. GENSLER. On pay parity, as I understand it, we've been able to bring up to a figure of about \$4 to \$4.5 million.

Senator DURBIN. I might say that there—

Mr. GENSLER. I'm sorry Senator, let me just correct this. There is \$1.4 million in the fiscal 2010 budget specifically with regard to that.

STUDENT LOAN REPAYMENT

Senator DURBIN. One obscure little thing which I accomplished when Senator Collins was chairing the Governmental Affairs Committee.

Senator COLLINS. Governmental Affairs.

Senator DURBIN. Governmental Affairs Committee, when it started, was the whole question of student loan repayment as an incentive to bring in professionals to Federal agencies.

The SEC is one of the best agencies in Government on this front, 385 of their staff, 181 of whom are attorneys have used the student loan repayment, and I believe this brings them into Federal Government where their services are very valuable. Otherwise they might not be able to consider it.

CFTC has not instituted such a program, probably for lack of money, and I'm wondering if you expect to be able to provide that benefit as part of recruitment in the future.

Mr. GENSLER. The answer is yes, sir, I think that we tried to do—I think it was just a small amount this year, \$200,000 in this fiscal year.

Senator DURBIN. I see.

Mr. GENSLER. In fiscal 2009, actually.

Senator DURBIN. Well, I think it can be a major part of attracting really talented college graduates who otherwise would be lured to something that may pay a little more just to defray their costs.

Mr. GENSLER. The agency shares that view.
 Senator DURBIN. Thank you.
 Senator Collins.

UNDERFUNDING

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Gensler, Senator Lieberman and I, as the chairman and ranking member of the Homeland Security and Governmental Affairs Committee, held three hearings last year looking at speculation in the commodities markets, and I want to talk about some of our findings as a result of those hearings.

The first we've already discussed at some length and that is that the CFTC has been woefully understaffed. We were told by the Commission that there were more than 3 billion futures and options contracts that were traded last year, I guess it would have been the year before last, and that was up from 37 million in 1976 when the Commission was first created, so 37 million to 3 billion contracts, and yet the Commission was operating with fewer employees than it had 30 years ago. Just an untenable situation.

Now, the Acting Chairman of the Commission in February wrote to the Office of Management and Budget (OMB) Director in protest of the budget that had been handed down by OMB of having a budget of \$160.6 million and he described it as perilously inadequate. He went on to say that it would not allow the Commission to implement all of its responsibilities. That is the budget that we're talking about today.

Do you disagree with the letter that was written by the Acting Chairman or do you share his concerns?

Mr. GENSLER. I share the concerns that this agency is both underfunded, as you and Senator Lieberman's panel determined last year. I think, as the Acting Chairman Mike Dunn did an excellent job these past 4 months laying out that this agency needs more. We're very appreciative of the President's budget and the 38 additional employees, but I don't think it's really yet up to the task that the American people expect or how we're going to protect against fraud, manipulation, and, as your hearings looked at, the burdens of excess speculation in these markets.

SPECULATION

Senator COLLINS. Let me turn to the speculation issue. As a result of the hearings that we held, Senator Lieberman and I introduced a bill that directed the CFTC to establish position limits that would apply to an investor's total interests in a commodity, regardless of whether they originate on a regulated exchange, the over-the-counter market or on foreign boards of trade that deal in U.S. commodities.

Do you support establishing position limits, having the Commission do it rather than the exchanges?

Mr. GENSLER. I think, Senator, that it's important that we bring a broader view of this even than was being discussed then, that we have the over-the-counter derivatives marketplace under regulation, but, in addition, that the position limits that are set—for instance, if it was for crude oil, that it would look across markets and aggregate not only internationally, as you were discussing, but also

with the over-the-counter derivatives marketplace. There may be contracts that are really quite similar, as you addressed in the farm bill, but more broadly as we work with Congress later this year and try to get aggregate position limit authority for Federal regulators to look across markets and across futures and swaps.

INDEX TRADERS

Senator COLLINS. What our hearings demonstrated was that speculation in the commodities markets by noncommercial investors, not individuals or entities that are actually taking possession of the commodity at some point, but entities, like pension funds, university endowments and other institutional investors, has grown enormously from 2003 to 2008.

In just that 5-year period the total value of their futures contract and commodity index funds investments soared from \$13 billion to \$260 billion. So you have this influx of money from speculators. There's always been speculation in the commodities futures markets.

I understand that and I understand that speculation is useful for hedging risk, but we're talking now about speculation from individuals who are not the traditional buyers and sellers of the commodity, and I understand that those investors' intention is to provide good returns as a hedge against inflation, asset diversification, but the effect of that activity cumulatively appears to drive up the price for some of the traditional users of the commodity markets.

Just a week ago Maine's fuel dealers were in my office saying that they believe excessive speculation by noncommercial players is once again driving up the cost of oil. That's a tremendous issue in a State where 80 percent of the families use home heating oil to stay warm.

So two questions. First, what is your general opinion on whether the influx of funds from nontraditional players is putting artificial price inflation or causing prices to go up beyond what they otherwise would, and second, what, if anything, should we do about it?

Mr. GENSLER. Two excellent questions. I do think that, looking back, in that period that you named and when oil prices peaked last summer, that a contributing factor, not the only factor because there were many factors, but a contributing factor to the commodity asset bubble was index investors and other financial investors.

We have also lived through other asset bubbles in housing, unfortunately, in the stock market in the late 1990s and then again maybe last year. So in a similar way, I think financial actors contributed to this but were not the only cause.

I do think that the Commodity Futures Trading Commission, at its core and has been for 70 plus years, one of its missions is to make sure that markets' integrity is sound, that there's not manipulation and fraud but also that the burdens of excessive speculation be guarded against through position limit authority.

So in terms of that mission, the Commodity Futures Trading Commission is not a price-setting agency, but it is an agency that has to guard to make sure that the markets are operating free of manipulation, free of fraud, and that through the position limit au-

thority the Congress first granted back in the 1930s, that there's some limit to the actors within the marketplace.

Senator COLLINS. Thank you.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, and thank you for those questions, Senator Collins.

I've just got a follow-up that goes right under her question and that is, do you think the marketplace right now is being impacted by—I'm talking about the oil marketplace is being impacted by trading of nontraditional traders?

Mr. GENSLER. Senator Tester, again I've only just been in the job for 6 days and mostly been preparing for this Appropriations hearing and a hearing for Thursday on other matters, so I haven't formed a view.

I do think that, just as the asset bubble broke last year with this financial crisis, that part of what we're seeing is with some confidence coming back in the stock market and in other investment markets, just as Senator Collins mentioned, some investments of firms and others are having more confidence in the value in the commodities marketplace.

But again, I've only been there 6 days and haven't, you know, been able to meet with economists and sort through the specifics of this market.

It is likely that, as economy—if we're able to get out of this recession and get away from the financial crisis, the commodity prices will move and I'm not saying where, but a lot will change in the economy, as well.

Senator TESTER. Being a farmer, I don't mind having commodity prices go up. I can tell you that the price of gasoline at the pump in Montana over the last 6 weeks has probably went up a buck a gallon. I don't see that kind of increase at the barrel level. I can still hear about ships floating around out in the ocean full of oil.

I can't make any sense of what's going on and what further frustrates me is that last year, during the last Congress, we had people in, and you're right, it was a multifaceted thing, but very, very few people would step up to the plate last year and say part of this—a good part of this is caused by speculation in the marketplace.

It was all supply and demand, supply and demand, supply and demand, and that was part of it, but I think a good part of it was just flat speculation and greed.

Mr. GENSLER. Senator Tester, as I just mentioned to Senator Collins before you arrived, I believe that index investors, hedge funds, and other pension and financial investors were a contributing factor in this asset bubble of last year. I just haven't been able to tease out exactly what's happened in my first 6 days.

Senator TESTER. I look forward to further communication, either in committee or outside the committee, on that issue because I think it's really important. I think it's really important that we make sure that we have honest markets here.

Mr. GENSLER. I fully agree with that.

MERGER

Senator TESTER. Okay. I asked a question to Secretary Schapiro about the discussions of future roles of your agency and the SEC

as we conduct a regulatory modernization effort, if they were combined, if CFTC were combined with SEC.

Can you just tell me some of the challenges, opportunities, possible consequences?

Mr. GENSLER. You said if.

Senator TESTER. That's right.

Mr. GENSLER. Well, thank you for your question, Senator. I think whether it's in Government or in commerce, it's important to consider that a merger just for merger's sake is probably not much reason to do that, whether it's in Government or in commerce.

Senator TESTER. Yeah.

Mr. GENSLER. I think some of the challenge is that each of these agencies, agencies that date back to the 1930s, have a mission to protect against fraud manipulation but with different missions.

At the CFTC, its core was around farmers and ranchers, which you know a great deal about, to protect their markets so they can hedge a risk, buy the seed and plant a crop knowing that the market pricing mechanism is honest.

That's at the core of the CFTC and if, for any reason, Congress and the President working together wanted to merge these agencies, which again I'm saying merger for merger's sake probably isn't it, we'd have to really protect that root mission, that we're protecting the pricing mechanism for farmers, ranchers, commercial users, all the users of the futures and derivatives marketplaces that the CFTC oversees.

Senator TESTER. Okay. If the President's working group recommends combining the two agencies, if again, and you believe that they should be separated, would you support the working group's regulatory modernization proposal?

Mr. GENSLER. I chair an independent regulatory agency. My responsibility, I think, to the American public would be to tell you what I believed at that time. So I think I would speak out openly and share with this subcommittee and the rest of the Congress what I thought.

DERIVATIVES REGULATION

Senator TESTER. All right. Good. Derivatives. You've been involved in a conversation on regulating or deregulating derivatives for over a decade in past positions that you've held.

Could you give me a quick synopsis, because I'm already out of time, on how your opinion of derivatives and the regulation has evolved over the last 5 to 10 years?

Mr. GENSLER. It has evolved, Senator. I think now that we must bring under regulation the over-the-counter derivatives marketplace through two complementary schemes.

One is the dealers or institutions that actually deal in these swaps, if I may call them, and that's nearly 100 percent of the market, probably in 20 or 25 big institutions. We know their names and you're familiar with them.

We should police for fraud manipulation. We should get 100 percent of the record, both for standardized and customized swaps and set capital standards at the Federal level and margin requirements through the dealer side.

But, in addition, in an additive way, also regulate the markets and then we can lower risk, we can lower risk if we have standard products go through central clearing and we can promote transparency and this is critical that we promote transparency through having regulated exchanges, as well.

Senator TESTER. Okay. Thank you very much, Mr. Chairman.

Senator DURBIN. Chairman Gensler, as you look at the volume of work that you're faced with, the new responsibilities, what do you think is the—let me state it this way.

What would you recommend as the optimal number of people that you need in your agency to do that job effectively?

Mr. GENSLER. Under the current authorities, because, of course, we'll work together with Congress and with the rest of the administration on new authorities,—thank you, Senator Tester.

Under the current authorities, the agency put forward, as Senator Collins said, an appeal letter in February that was speaking to—I think it was about 650 full-time people under that \$177 million.

I don't know yet, again through just 6 days, whether that's going to allow us to fully cover, but I agree with Acting Chairman Dunn that it's more toward that number of people and it may be as high as some figures I've seen inside that are a little higher than that, closer to the 700-person figure.

ENFORCEMENT PENALTIES: AMOUNT, RECOVERY AND DETERRENCE

Senator DURBIN. When Chairman Schapiro was here, I noted that the fees collected by her agency within the marketplace generated about 40 percent more than the annual appropriation for her agency.

Similarly, in your situation, the penalties that have been assessed for wrong-doing and the amounts collected, I've seen varying estimates of this amount, but they appear to be over the last 8 years somewhere between \$1.5 and \$2 billion your annual appropriation, for last year \$146 million, in comparison there.

So could you say to me, I mean, or could we say to those who are observing this hearing that when your agency does its job and ends up with a trustworthy marketplace, it also is engaged in enforcement actions which bring in more revenue than the actual budget of the agency?

Mr. GENSLER. I think, Mr. Chairman, that the agency—we could say to those looking at this is a sound investment of a \$160 million for the next year of taxpayer money because in helping police these markets, enforcing these markets, bringing integrity to the markets, making sure that they're fairly priced in the marketplace is the crucial thing.

But in addition, you're right, there are enforcement actions that have penalties. The penalties are at least greater than the budget. The collections tend to be a little less than that, as you know.

Senator DURBIN. How well is the CFTC able to measure the deterrent impact of these enforcement actions?

Mr. GENSLER. It's a challenge to measure the results, but we believe that the stronger we are in enforcement, just as Chairman Schapiro said, in finding some of those cases that you can really

bring the wrong-doers to bear is critical to make sure that the markets operate better.

Senator DURBIN. What is your recovery rate?

Mr. GENSLER. As I understand it, the collections on the large manipulation cases are very high. The collection on the Ponzi schemes and fraud cases, unfortunately, is very low because so often those individuals behind those cases don't have any money, but I believe it's somewhere in the 30 to 40 percent when you average out high recoveries on complex manipulations and low recoveries on these Ponzi schemes.

Senator DURBIN. I'd like your thoughts, and maybe you can share them with me in separate communication, about whether the current penalty structure is in fact at a level consistent with creating a deterrent and what additional remedies or instruments you may need for that recovery rate to improve, and I understand that, as you said, some recovery is going to be extremely difficult.

But if you would take a step back and look at those two aspects, the deterrence and recovery, and give us your thoughts on that, I would appreciate that very much.

Mr. GENSLER. We will follow up with you, Mr. Chairman.

Senator DURBIN. Thank you.

Senator Collins.

DERIVATIVES REGULATION

Senator COLLINS. Thank you, Mr. Chairman.

Just two final questions from me. Senator Levin and I have introduced a bill that would repeal the language that prohibits the Commodity Futures Trading Commission from regulating derivatives, and I understand that the administration's new proposal would give both the SEC and the CFTC new authority to regulate derivatives.

What are your thoughts on this plan and the role of the CFTC in the regulation of derivatives?

Mr. GENSLER. I wish to applaud you and Senator Levin on that bill. I believe that we have to have, working with Congress, significant amendments to the Commodities and Exchange Act and seeking the same goal, to bring all the over-the-counter derivatives marketplace under regulation.

I think the Commodity Futures Trading Commission has the lead expertise on derivatives. Futures are a form of derivatives and these things that are now called over-the-counter swaps are another form of derivatives.

Working with Chair Schapiro, I'm hopeful that we can present a unified front and, as she said, you know, there's the boundary issues are important.

I think it's critical that we not have any gaps in regulation, but we believe at the CFTC and I believe interest rate swaps, currency swaps, commodity swaps, equity swaps, credit default swaps and any swaps invented in the future that are just a blip on the radar need to come under this regulatory regime.

There may be areas where a swap is more security-like, like a single issuer credit default swap, where, of course, we need multi-agency work, insider trading and SEC, you would want very much involved in things like that.

Senator COLLINS. Actually, I would argue that the credit default swaps were more like an insurance product and yet they were not regulated by State insurance agencies either.

Mr. GENSLER. They had many insurance attributes. There were many lessons, unfortunately, out of this crisis. You were earlier asking Chair Schapiro, but I think one of the great lessons of AIG was that there was unregulated institutions. That's why I am for regulating all derivative dealers, whether they're affiliated with banks or not.

But then these products, as you say, credit default swaps, have attributes of insurance, like monoline insurance. They have attributes of securities.

Senator COLLINS. Exactly.

Mr. GENSLER. They have attributes of derivatives that the CFTC is the expert on.

Senator COLLINS. Which is why we need this council of regulators approach because the problem now is the marketplace is always going to be innovating and we want it to be innovative and producing new kinds of products and we need a system where just because a product is new does not mean that it falls into a regulatory black hole and no regulator ends up having responsibility and no regulator or regulators is looking at the impact across the financial system.

When you think of a credit default swaps situation, here we have a new product that grows into the trillions of dollars, jeopardizes the entire financial market, and yet it doesn't fall under securities, it doesn't fall under insurance, it doesn't fall under the Consumer Product Safety—I mean the Commodity Futures Trading Commission. So clearly, we need to resolve that.

Let me just turn to another loophole that our hearings took a look at and that's the so-called swaps loophole that allows financial institutions to evade position limits on commodity contracts that regulators are using to prevent unwarranted price swings or attempts at manipulation.

What should be done to close that loophole?

Mr. GENSLER. I think that explicit authority should be given to the Federal regulators, with the CFTC taking the lead on position limits, to bring the over-the-counter derivatives marketplace under a regulatory regime: that we regulate all of the dealers to make sure that they are not manipulating, that we're policing fraud, that we're policing position limits, aggregate position limits, as I referred to earlier, that we, amongst the regulators, have an enormous opportunity to see 100 percent of the transactions.

INTERNATIONAL

Senator COLLINS. Finally, do you have sufficient funds to pursue your international responsibilities?

What I'm thinking of is there is a problem with foreign exchanges and what rules they're going to play by, particularly if they're dealing with U.S. commodities which they are, and particularly when they have a presence in the United States.

I don't know whether that's an issue you've looked at yet, but the SEC seems to be far more active in that area than the CFTC is.

Mr. GENSLER. Well, Senator, you're right that we've had to make as an agency tough trade-offs, an agency that shrunk 20 percent in the last years, but thankfully with this year we'll start to move back.

There's a small Office of International Effort but it's very small, I think four or five people at the CFTC. We do share your concern and share the view that we have to make sure that foreign boards of trades that are influencing these markets and are in our markets have consistent regulation, come under the position limits and other authorities here.

Though the CFTC has moved forward in this regard, we do think that it's important to work with Congress to embed in statutes some additional authorities with regard to foreign boards of trade.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Collins.

ADDITIONAL COMMITTEE QUESTIONS

Chairman Gensler, thanks for your testimony. We're going to keep the hearing record open until next Wednesday, June 10, at 12 noon for subcommittee members to submit statements and/or questions, and we ask that the information we requested you do your best to comply with at a convenient time.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

MOST SERIOUS MANAGEMENT CHALLENGES IDENTIFIED BY INSPECTOR GENERAL

Question. The Reports Consolidation Act of 2000 requires the Inspector General to summarize the "most serious" management and performance challenges facing the Commodity Futures Trading Commission (CFTC). In the Inspector General's assessment report of November 14, 2008, the Inspector General identified two management challenges for fiscal year 2009.

The first concern is with the Modernization of Electronic Market Surveillance. The Inspector General explains that while market surveillance has always been an integral part of CFTC operations, the past years have witnessed the transformation of futures trading from an open outcry trading floor based system to an electronic system. In fact, in 2008, electronic trading accounted for 84 percent of total exchange traded derivatives.

The second area is the Efficient Acquisition and Integration of Skilled Human Capital. The Inspector General cites the fact that recent economic turbulence has stimulated an interest in applying the historically successful centralized clearing mechanism to the bilateral and complex swap markets. The Inspector General expressed skepticism that the CFTC currently has the human capital to monitor these complex markets and that situation may demand review of existing hiring procedures.

Chairman Gensler, have you had an opportunity to review the Inspector General's analysis?

What is your reaction?

What is your plan for prioritizing these two key items in your management agenda?

Answer. Yes, certainly the need to modernize electronic market surveillance will require additional technological capabilities. It is also apparent that if the Congress entrusts the Commission with significant additional responsibilities, the Commission will need to expand its staff and pay particular attention to needed skill sets. The Congress provided the Commission with substantial additional funds for fiscal year 2009. At this point we have almost completed hiring the new staff funded for this year. I asked the staff to provide the following information on the modernization of electronic market surveillance:

In late 2008, the CFTC contracted with the Promontory Group to review the market surveillance program. Commission staff is finalizing its assessment of the Promontory report and preparing recommendations for the Commission. The objective is to ensure that the CFTC has an effective approach to surveillance, from both a programmatic and operational perspective.

The CFTC also is in the process of modernizing its trade surveillance system in order to perform its statutorily mandated oversight functions and to keep pace with the explosive growth in electronic trading. In 2007, the CFTC's Division of Market Oversight ("DMO") and Office of Information and Technology Services ("OITS") embarked on a multi-year plan to develop a new trade surveillance system ("TSS"), to replace the Commission's antiquated system. TSS is designed as a database of exchange data maintained by the Commission which can be evaluated with off-the-shelf alert and analysis tools. A contract was awarded to Actimize in 2008 to deliver such a product. OITS expects to have all of the exchanges connected to the Actimize tool by the end of the first quarter 2010.

A challenge to the Commission in implementing TSS has been a lack of data uniformity. To resolve this problem, in May 2007, DMO formed a subcommittee through the Joint Compliance Committee to discuss and formulate a plan for using "FIXML" as a standardized format for trade data submitted to the Commission and to formulate a FIXML transition plan. In December of 2008, a schedule was presented to all exchanges for submission of trade data in FIXML by the end of 2009.

The Commission has also been working to better link its trade surveillance and market surveillance systems. Currently, the Commission is unable to connect accounts identified by large traders with their intra-day transactions. To resolve this problem, the Commission has issued an advanced notice of proposed rulemaking to solicit comments on the collection of account ownership and control information from exchanges. Such information would be used to improve DMO surveillance by serving as an adjunct to the CFTC's ISS (large trader position data) and TSS databases.

ADEQUACY OF FUNDING TO PERMIT PAY PARITY

Question. In response to the 1980s banking crisis, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Public Law 101-73) which provided for pay parity among federal financial regulatory agencies.

The Commodity Futures Trading Commission was granted comparable pay authority (Public Law 107-171) with other financial agencies to level the playing field with a goal of attracting the best and brightest talent. Despite the authorization, the CFTC has not been fully funded to the level of comparable agencies covered under the law.

During recent years, the Commodity Futures Trading Commission's budget situation has resulted in hiring freezes and has not permitted a meaningful review by the IG to determine its effect on employee retention and whether new hires are appreciably more experienced or better qualified.

Chairman Gensler, what has been the practical impact of the CFTC's not having sufficient annual budget authority to accomplish pay parity for your workforce?

Answer. The Commission is currently near pay parity with the other FIRREA agencies with regard to pay, having implemented merit pay and new pay ranges. There are several areas where we need to align the Commission with the FIRREA agencies; these include personnel benefits and possibly some job reclassification.

The implementation of pay parity without sufficient budget authority has had the same practical effect as meeting all other resources challenges without sufficient budget authority—the Commission froze and/or restricted hiring and deferred investment in Information Technology. These steps were taken after exhausting all other savings from administrative efficiencies.

Question. To what extent has the CFTC's inability to compensate staff at comparable levels led to departures of experienced personnel to positions in other Federal financial regulatory agencies?

Answer. Since the Commission is currently comparable with other FIRREA agencies with regard to pay, and nearly comparable with regard to benefits, the Commission is no longer losing, as it once did, a significant number of staff to other financial regulatory agencies as a result of inadequate compensation. However, those past losses tell us it is important that the Commission maintain comparability with these agencies.

Question. What funding level would permit the CFTC to move toward providing pay parity?

Answer. The fiscal year 2010 budget includes approximately \$1.4 million that would permit the Commission increased contribution to personnel benefits package thereby making it more comparable to FIRREA agencies. Funding would also permit

the Commission to reclassify selected positions if an ongoing review concludes that is appropriate to support parity and to improve recruitment and retention.

Question. As CFTC Chairman, what are your goals in this area?

Answer. As a new Chairman I look forward to reviewing the findings and recommendations of the Commission Pay Parity Governance Committee before advancing any new goals of my own. However, I am committed to ensuring that the Commission receives adequate funding to stay comparable with our fellow financial regulatory agencies.

Question. When does the CFTC plan to institute a student loan repayment program as a recruitment and retention tool?

Answer. Our goal is to implement a student loan repayment program by the end of the year.

Question. What resources would that require?

Answer. We have initially set aside \$200,000 for the implementation of this program.

DERIVATIVES MARKET REGULATORY REFORM

Question. Derivatives—contracts between two investors betting on whether a stock, bond, or other security will go up or down in value—has ballooned into the world's largest trading market, estimated to be in the tens of trillions of dollars. Much of the activity is not currently under a regulatory apparatus.

This market has also helped catalyze the current economic crisis. Losses on one type of derivative known as credit-default swaps helped topple American International Group (AIG), prompting a government bailout that has grown to \$180 billion.

On May 13, President Obama unveiled a plan to regulate the derivatives market. This proposal includes new rules to restrict banks, hedge funds, and other investors, and has four goals: (1) force the trade of most derivatives through a regulated clearinghouse and require traders to report activities and hold a minimal level of capital to cover losses; (2) improve oversight by ensuring clearinghouses and firms dealing in derivatives provide copious information to regulators about their trades; (3) empower regulators to force traders to submit detailed information and pursue cases of fraud and manipulation; and (4) prevent derivatives from being marketed to groups that may not understand their complexities.

How would expanded derivatives regulation impact the CFTC workload? What budgetary considerations need to be considered?

Answer. We must establish a comprehensive regulatory regime to cover the entire over-the-counter derivatives marketplace. This will help the American public by: (1) lowering systemic risk; (2) providing transparency and efficiency in markets; (3) ensuring market integrity by preventing fraud, manipulation, and other abuses; and (4) protecting the retail public. I envision this will require two complementary regimes—one for regulation of the dealers and one for regulation of the market functions.

The Department of the Treasury, on behalf of the Administration, has submitted legislation to Congress to regulate the over-the-counter (OTC) markets. Although some improvements are appropriate to ensure that we best meet the goals stated above, the Administration's comprehensive proposal is consistent with regulatory reforms that the CFTC has proposed in testimony to Congress. The Administration's proposal will lower risk by requiring capital and margin on dealers and mandatory clearing of all standardized products. It will enhance market integrity by protecting against fraud, manipulation, and other abuses and establishing new authorities to set aggregate position limits. It will promote transparency and market efficiency by requiring recordkeeping and reporting for all derivatives and requiring that standardized derivatives be traded on transparent trading platforms.

Of course there would be a need for some additional resources at the CFTC to handle this expanded regulatory obligation. Until the nature and scope of the regulation of OTC derivatives markets is determined by the Congress, the resources necessary for implementation cannot be predicted with certainty.

Whatever the cost of regulation, it will pale in comparison to the cost of doing nothing. If the current financial crisis has taught us anything, it is that the derivatives trading activities of a single firm can threaten the entire financial system. The costs to the public from the failure of these firms has been staggering, \$180 billion of American taxpayer financial support for AIG alone. The AIG subsidiary that dealt in derivatives was not subject to any effective federal regulation.

MEMORANDUM OF UNDERSTANDING BETWEEN CFTC AND SEC

Question. Last year (March 11, 2008), then-Commodity Futures Trading Commission (CFTC) Acting Chairman Walter Lukken and then-Securities and Exchange Commission (SEC) Chairman Christopher Cox entered into a formal "Memorandum of Understanding" (MOU) setting forth several principles designed to guide inter-agency collaboration. The premise of this agreement was to seal some of the regulatory gaps and better accommodate new products that blur the lines between the futures and the securities worlds.

The MOU establishes a permanent regulatory liaison between the CFTC and SEC; requires quarterly joint meetings of staff; sets up a framework for extensive information sharing and exchange confirms existing enforcement policies; creates guidelines for new financial products that combine elements of securities, futures, or options; and addresses jurisdictional overlaps.

Chairman Gensler, can you describe some of the benefits to the CFTC since entering into the MOU with the SEC in March 2008?

Answer. The MOU has provided a formal mechanism to assure dialogue among senior staff of the two agencies regarding the treatment of novel derivative products and other issues of mutual regulatory interest. In addition, following on the MOU, the CFTC and SEC Divisions of Enforcement undertook efforts to improve coordination and cooperation. Specifically, in the summer of 2008, the CFTC and SEC Divisions of Enforcement appointed senior staff to serve as liaisons for their respective agencies, and also established quarterly meetings to discuss issues related to investigation and litigation dockets for matters of common concern. The enhanced cooperation between the CFTC and SEC Divisions of Enforcement is also reflected in the May 2009 joint training session for enforcement staff in which experts from both agencies discussed strategies regarding the agencies' coordination, investigation and prosecution of several recent Ponzi fraud matters.

Question. What impediments hinder CFTC's ability to oversee and regulate new products that have mixed characteristics of futures and securities?

Answer. Neither the CFTC nor the SEC currently has regulatory jurisdiction with respect to OTC derivatives transactions, some of which are relevant to both the futures and the securities markets. In areas where jurisdiction does exist, further enhanced communication between the CFTC and SEC staff—specifically, ongoing communications regarding whether activity detected by one agency implicates the jurisdiction of the other agency—will improve the CFTC's ability to oversee and regulate such new products.

Question. How do you intend to collaborate with SEC Chairman Schapiro in advancing the goals of this MOU?

Answer. In addition to direct communications with Chairman Schapiro, as we have done in discussing regulatory reform with respect to OTC derivatives, I anticipate that Chairman Schapiro and I will actively direct and guide our respective staffs to fulfill the objectives of the MOU. We will work cooperatively and collaboratively to remove unnecessary duplication and other regulatory roadblocks to innovative market developments, while assuring that there are no regulatory gaps that endanger the public interest. The agencies' focus on this goal is currently reflected in our joint harmonization project, including the unprecedented joint meetings recently held by our two Commissions.

Question. Do you envision the need for any modifications to the agreement to strengthen the current interagency relationship?

Answer. The MOU was intended to be a "living" document. Just as the agencies have entered into an Addendum to the MOU with respect to novel derivative products, additional Addenda may be considered as the agencies address new issues and harmonization on a going-forward basis.

ENFORCEMENT ACTIONS TO PRESERVE MARKET INTEGRITY AND PROTECT MARKET USERS

Question. Detecting and deterring against illegitimate market forces requires CFTC's steady vigilance and swift response. Over the past 8 years, CFTC has assessed over \$2 billion in civil penalties against perpetrators of various fraud schemes. For instance:

- To address manipulation, attempted manipulation, and false reporting in the energy arena, the CFTC filed 43 enforcement actions against 73 entities or individuals in the December 2001 to September 2008 period resulting in \$445.5 million in assessed civil penalties.
- To address misconduct in connection with commodity pools and hedge funds by unscrupulous and unregistered operators and advisors, from October 2000 and September 2008, the CFTC filed 73 enforcement actions against 24 entities, with \$564.13 million in penalties assessed.

—To combat the problem of foreign currency (forex) fraud, between December 2000 and September 2008, on behalf of nearly 26,000 affected customers, the CFTC has filed 98 enforcement actions, charging 374 entities or persons, culminating in over \$562 million in civil monetary penalties and \$454 million in restitution.

How well is the CFTC able to measure the deterrent effect of these enforcement actions?

Answer. Measuring the deterrence effect of enforcement actions remains a challenge to the CFTC and other law enforcement agencies. The CFTC has undertaken a number of actions to increase deterrence as noted below by staff:

—The CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. In cases of ongoing fraud, the CFTC's objective is to bring its enforcement action as quickly as practicable in order to stop the fraud, freeze assets, and preserve books and records. The CFTC also leverages the impact of its enforcement actions by working cooperatively with federal and state criminal and civil authorities who often bring their own actions based upon the conduct that violates the Commodity Exchange Act and CFTC Regulations. Whenever the CFTC files an enforcement action and obtains a final judgment in one of its enforcement actions, it publicizes these events through press releases and media interviews. To alert market users and the public to the dangers of fraud, the CFTC has issued a number of Consumer Advisories warning the investing public of potential risks and scams, and has posted these Advisories on its website. The CFTC also seeks to maximize the deterrent effect of its enforcement program by tracking industry trends. For example, the CFTC's Acting Director of Enforcement gave Congressional testimony in June 2009 regarding the observed uptick in fraud involving solicitation of retail customers for purported off-exchange transactions in precious metals, and certain energy and agricultural products. The fraudsters appear to have drafted customer agreements to make them appear to be spot contracts outside of CFTC jurisdiction and not futures contracts covered by the Commodity Exchange Act.

—The CFTC remains committed to developing improved performance measures to reflect the deterrence effect of its enforcement program. For example, the CFTC has requested funds every year since the fiscal year 2007 OMB budget request thru fiscal year 2010, to study the performance measurement issue, however, funds, to date, have not been approved.

Question. How rapidly are you able to collect restitution, disgorgement of ill-gotten gains, and civil monetary penalties imposed against violations of the federal commodities laws?

Answer. When the CFTC files enforcement actions that include allegations of fraud, its general practice is to seek a statutory restraining order to immediately freeze the defendants' known assets, including trading and bank accounts, homes and other real property and cars. These assets are then preserved for purposes of customer restitution or disgorgement at the conclusion of a successful prosecution. The CFTC Division of Enforcement may also request that the federal district court order defendants to make an accounting, which assists the CFTC in tracking money flows and identifying additional assets for recovery. The CFTC also names as relief defendants in its enforcement actions persons known to have received funds derived from the fraud and to which they have no legitimate claim, and seeks to freeze and recover these funds for return to customers as well. At the conclusion of litigation, and in the event of a remaining judgment, the Commission follows an established protocol to ensure that matters are appropriately referred to the Department of Justice and Department of the Treasury for collection.

Question. What is the annual recovery rate?

Answer. Staff has supplied the following information:

Below is a table that sets out the CFTC's annual recovery rate for civil monetary penalties assessed for fiscal years 1992 through 2008.

CIVIL MONETARY PENALTIES ¹
[Fiscal year 1992-fiscal year 2008]

| Fiscal year | Penalties imposed | Penalties collected |
|-------------|-------------------|---------------------|
| 1992 | \$3,207,277 | \$2,285,664 |
| 1993 | 3,313,100 | 3,514,715 |
| 1994 | 4,112,407 | 3,134,266 |
| 1995 | 11,201,100 | 9,430,239 |
| 1996 | 1,335,000 | 1,526,000 |

CIVIL MONETARY PENALTIES ¹—Continued

[Fiscal year 1992-fiscal year 2008]

| Fiscal year | Penalties imposed | Penalties collected |
|-------------|-------------------|---------------------|
| 1997 | 4,532,000 | 1,752,636 |
| 1998 | 132,623,756 | 125,803,781 |
| 1999 | 85,863,311 | 22,165,368 |
| 2000 | 179,811,562 | 3,299,362 |
| 2001 | 16,876,335 | 3,170,252 |
| 2002 | 9,942,382 | 5,922,387 |
| 2003 | 110,264,932 | 87,699,077 |
| 2004 | 302,049,939 | 122,468,925 |
| 2005 | 76,672,758 | 34,163,077 |
| 2006 | 192,921,794 | 12,364,509 |
| 2007 | 345,614,139 | 17,137,848 |
| 2008 | 234,835,171 | 140,745,252 |

¹The discrepancy between the amount of civil penalties imposed and the amount collected is accounted for by the following factors: (1) when courts order the defendants to both pay restitution to victims and a civil monetary penalty to the Government, established Commission policy directs available funds to satisfy restitution obligations first; (2) in fraud actions, it is not uncommon that the proceeds of the fraud have been dissipated and/or that the penalty far exceeds the defendants' represented financial ability to pay; (3) delinquencies assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (4) penalties imposed in one year may not become due and payable until the next year; (5) a penalty may be stayed by appeal; (6) some penalties call for installment payments that may span more than 1 year; (7) penalties have been referred to the Attorney General for collection; and (8) collection may still be in process.

Question. What has been the impact of more sophisticated information technology to monitor and detect fraud more readily?

Answer. In the enforcement arena for fraud cases, information technology assists in asset tracing, account reconstruction, and electronic data recovery of financial records. Improvements in information technology have improved the CFTC's search capability for evidence of illegal activity involving Internet websites, instant messages, e-mail and audio.

In the regulatory arena, as discussed above, the CFTC is currently implementing its new trade practice surveillance system (TSS). TSS is designed as a database of exchange trade data maintained by the Commission upon which off-the-shelf alert and analysis tools can be connected. A contract was awarded to Actimize in 2008 to deliver an alert and analysis tool that has the capability to perform sophisticated pattern recognition and data mining to automate basic trade practice surveillance, and to detect novel and complex abusive practices. TSS also will fill a vacuum in inter-market surveillance which only the Commission can address, e.g., where NYMEX and NYSE Liffe both list metals contracts.

Question. Are there any statutory or administrative impediments that prevent the CFTC from doing more to combat fraud?

Answer. As noted above, the CFTC has observed an upswing in retail customer complaints regarding potential fraud involving off-exchange transactions in precious metals, energy products and agricultural commodities. It appears that fraudsters are drawing upon the adverse precedent of a line of cases under *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), in which the Seventh Circuit held that certain contracts were spot transactions beyond the jurisdiction of the CFTC. Congress addressed this problem in the CFTC Reauthorization legislation included in the 2008 Farm Bill with respect to Zelener-type foreign currency transactions. A similar fix is needed if the CFTC is to effectively prosecute boiler rooms offering Zelener-type contracts in metal, energy, and other commodity contracts to retail customers (and is included in the Administration's proposed OTC derivatives reform legislation).

In addition, in the wake of the decision in *CFTC v. Wilshire*, 531 F.3d 1339 (11th Cir. 2008), defendants in fraud cases increasingly are asserting that federal courts lack authority under the Commodity Exchange Act to award restitution based on customer losses suffered as a result of the fraud. *Wilshire* held that the proper measure of restitution is the gain to the wrongdoer, rather than the losses suffered by customers. In cases where the fraudster retains only a small portion of the monies fraudulently induced from customers, this limit on restitution threatens the CFTC's ability to obtain make-whole relief for defrauded customers.

Staff advises that additional statutory measures that may increase the CFTC's ability to combat fraud include, among others, the following:

—Amendment of the Privacy Act to clarify that CFTC investigators may seek promotional material and verbal sales solicitations without identifying themselves as CFTC employees or providing personal information as to their true identity.

—In Section 4n of the Commodity Exchange Act, provide authority to require accountants to maintain records of audit activity concerning commodity pools that would be available for inspection by the CFTC.

—Clarify that the CFTC need not show criminal intent in actions based on conversion under Section 9(a)(1) of the Commodity Exchange Act.

Question. Is the current penalty structure designed to serve as an effective deterrent?

Answer. Yes. Commission staff supplies the following background:

—Section 6(e) of the Act, 7 U.S.C. § 13a-1(d), instructs the Commission to impose a civil monetary penalty that is appropriate to the gravity of the violation. Commission precedent has long recognized the importance of deterrence in preventing violations, most recently in *In re DiPlacido* [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶30,970 (CFTC Nov. 5, 2008) (“[g]iven the gravity of DiPlacido’s offenses and potential maximum fine, the focus of the Commission’s analysis shifts to assessing a specific penalty appropriate to the level of gravity and suitable to deter future violations”). Indeed, the Commission signaled the paramount role that deterrence plays when it emphasized that “[i]n imposing monetary sanctions, the primary focus of the Commission’s analysis has been deterrence.” *In re Murlas*, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,440 at 35,929 (CFTC Apr. 24, 1989) (emphasis added).

—Also, in last year’s CFTC Reauthorization legislation, Congress increased the maximum civil monetary penalty for manipulation, attempted manipulation, and false reporting to \$1 million per violation. See Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008); 7 U.S.C. § 13(a).

Question. What additional remedies or authorities might be useful to boost your recovery rate?

Answer. Staff has advised that additional statutory measures that could potentially boost the CFTC’s recovery rate include, among others, the following:

—Similar to provision for non-payment of penalties imposed in CFTC administrative enforcement actions (see Section 6(e)(2) of the Commodity Exchange Act), provide that a defendant’s non-payment of civil monetary penalties imposed in enforcement actions in federal court shall result in the non-paying defendant automatically being prohibited from trading and automatically suspending any applicable registration until the defendant pays the full amount of the penalty, with interest to the date of the payment.

—Provide that collection of judgments and orders in fraud actions shall not be subject to State homestead exemptions or other State or local impediments to collection.

—Provide that disgorgement and restitution awarded in CFTC enforcement actions are non-dischargeable in bankruptcy.

—Add disgorgement as an available sanction in administrative enforcement proceedings.

PERFORMANCE GOALS/MEASURING OUTCOMES

Question. The Commodity Futures Trading Commission (CFTC)’s performance-based budget for fiscal year 2010 delineates four specific goals tied to the agency’s overall mission. For each of the goals, several outcomes are specified.

First Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$48.2 million (or 30 percent of the total funding) and 185 FTE to meet the first goal—to ensure the economic vitality of commodity futures and options markets.

The outcomes to be achieved as a result of the investment made related to this goal are markets that accurately reflect the forces of supply and demand for the underlying commodity, are free of disruptive activity, and are effectively and efficiently monitored to ensure early warning of potential problems or issues.

How does (or will) the CFTC measure whether and how well these outcomes are achieved?

Answer. The Commission has developed nine performance measures intended to measure progress in achieving the stated outcome objective. The performance results along with an annual performance analysis and review are included in pages 46–55 of the Fiscal Year 2008 Performance and Accountability Report available on the CFTC website at: www.cftc.gov/aboutthecftc/cftcreports.

Question. How does the CFTC intend to meet a performance goal of “no price manipulations or other disruptive activities that would cause loss of confidence or negatively affect price discovery or risk shifting”?

Answer. This goal is fundamentally tied to the Commission's mission and is a priority of the Commission market surveillance and enforcement efforts as noted by staff below:

—Continuous monitoring of market activity is the principal way the Commission seeks to protect the economic function of the markets. Effective market surveillance requires sufficient staff with expertise in each of the diverse markets under the Commission's jurisdiction. The Commission takes preventive measures to ensure that market prices accurately reflect fundamental supply and demand conditions, including the routine daily monitoring of large trader positions, futures and cash prices, price relationships, and supply and demand factors in order to detect threats of price manipulation.

—As discussed above, the CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. The CFTC also leverages the deterrent impact of its enforcement actions by working cooperatively with other federal criminal authorities who often bring their own actions based upon the conduct that violates the Act and CFTC Regulations.

Question. When it comes to a performance goal of "improving effectiveness and efficiency of market surveillance" what indicators will be used to determine if you have indeed reached this goal and how well? What is the baseline from which progress is to be measured?

Answer. A strategic priority of the Commission is to enhance the Commission's technological capability, improve data standards, and enhance in-house human analytical and decisionmaking capability—each in order to recognize, understand and adapt to market changes early on. Indicators of success will be progress in achieving the following tasks: upgrading ISS to get more timely market position information and to integrate trading data with position data; developing capability to provide real-time margin and settlement information; promoting data standards throughout the industry; developing and implementing sophisticated trade surveillance systems; developing automated capability to analyze and integrate off-exchange data as it relates to surveillance and investigations; developing a recruitment plan to address required skills; identifying needed competencies and developing a training plan that empowers employees to react quickly in understanding and resolving regulatory matters. Each of these tasks represents a strategic need of the Commission that is not currently being met adequately.

Question. Second Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$42.9 million (or 27 percent of the total funding) and 160 FTE to meet the second goal—to protect market users and the public. The three outcomes to be achieved as a result of the investment made related to this goal are better detection and prevention of violations of commodities laws, high standards for professionals, and expeditious handling of customer complaints.

How does the CFTC plan to increase the probability of violators being detected and sanctioned?

Is this readily measurable?

What is the baseline against which future performance will be gauged?

Answer. Having sufficient resources to pursue violations is key to increasing the probability of violators being detected and sanctioned. The Commission has developed four performance measures to assess progress in detecting violators. The performance results along with an annual performance analysis and review are included in pages 58–63 of the Fiscal Year 2008 Performance and Accountability Report available of the CFTC Web-site at: www.cftc.gov/aboutthecftc/cftereports.

Like all enforcement programs, we face a challenge in establishing overall performance measures that indicate the percentage of violative activity deterred, since no way has yet been devised to measure the total universe of violative activity that exists. The Commission keeps extensive records on the number of investigations opened and cases filed during the year, the number and amount of sanctions obtained, as well as the number of cases filed by criminal and civil law enforcement authorities that included cooperative assistance from the Commission. However, these statistics do not measure complexity of the matters opened and filed. For example, the Commission met its performance target in fiscal year 2008 with regard to the number of enforcement investigations opened. However, commencing in 2002, the complexity of Commission investigations has increased substantially over prior years (including the Commission's investigation of alleged energy market manipulation). As a result of these investigations, the complexity of the Commission's cases filed and litigated also has increased substantially since 2002. The Commission's performance target tries to take into account both of these factors but they cannot be predicated with precision.

Question. How will the CFTC ensure there are "zero unregistered, untested, or unlicensed commodity professionals (unless they are exempt from registration)"?

Answer. There are several complementary aspects to the Commission's program that ensure compliance with registration requirements as summarized by staff below:

—*Registration and NFA Membership.*—Under Section 17 of the Commodity Exchange Act ("CEA"), the National Futures Association ("NFA") performs registration functions on behalf of the CFTC. NFA registers members through its Online Registration System ("ORS") a web-based registration and membership filing and processing system. With certain exceptions, all persons and organizations that intend to do business as futures professionals must register under the CEA. The primary purposes of registration are to screen an applicant's fitness to engage in business as a futures professional and to identify those individuals and organizations whose activities are subject to federal regulation.

In addition, all individuals and firms that wish to conduct futures-related business with the public must apply for NFA membership or associate status. Mandatory membership serves an important function: NFA Bylaw 1101 prohibits members from conducting customer business with non-NFA members.

—*Testing.*—Individuals who are applying for NFA membership as a sole proprietor FCM, IB, CPO, CTA or for registration as an AP of any of these categories must satisfy proficiency requirements. Applicants generally must have passed the National Commodity Futures Examination (NCFE or Series 3) within the 2 years preceding their application.

—*Ethics Training.*—The CFTC Statement of Acceptable Practices (see Appendix B to Part 3 of the Commission's regulations) for ethics training allows flexibility, permitting firms to tailor their training programs to best suit their particular operations. In an Interpretive Notice to its Compliance Rule 2-9, NFA states that good business practice dictates that employees receive periodic training to keep them cognizant of new developments in technology, commercial practices and regulations, and their ethical implications.

—*Oversight.*—NFA conducts ongoing audits of its registrants for compliance with NFA rules. In turn, Commission staff pursues formal and ongoing oversight of NFA's compliance and registration programs. Formal oversight activities involve periodic reviews of NFA programs and inspection of records and interviews with NFA staff.

NFA pursues statutory disqualification and other disciplinary matters through Registration, Compliance & Legal Committee ("RCLC") cases. On a quarterly basis, Commission staff meets with NFA to provide guidance on registration issues generally, and to review the past quarter's RCLC cases.

These oversight activities are designed to protect market participants and the public interest by ensuring that persons who deal with customers and those who handle customer orders and funds meet the standards for fitness and integrity established under the Commodity Exchange Act.

Question. What type of tracking system is in place to demonstrate that this outcome has been achieved?

Answer. Currently, there are more than 67,000 individuals and companies registered with the CFTC in some capacity. Although it would be impossible to track the negative (i.e., that there are unregistered individuals conducting business), through its oversight of NFA's registration program, the Commission ensures both that qualified applicants are properly registered, and that unqualified applicants (or registrants) are denied registration (or have their registration revoked). Through the quarterly meetings of the Registration Working Group involving CFTC and NFA staff, the Commission ensures that standards for such actions are applied consistently, and gives guidance when questions arise.

Question. With regard to meeting timeframes for resolution of customer complaints, how does the CFTC track disposition of complaints, proceedings, and appeals in order to show that the targets are achieved in the caseload?

Answer. The various Divisions at the CFTC (Enforcement, Clearing and Intermediary Oversight, Market Oversight, and General Counsel's Office) each operate an "officer of the day program" to receive, and address or refer, inquiries (including complaints) from members of the public. The Office of Proceedings handles and tracks the disposition of adjudicatory matters at the hearing level. With respect to adjudicatory appeals to the Commission, pending cases are maintained with the Secretariat, with monthly status reports issued by the Office of General Counsel.

Question. Third Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$38 million (or 24 percent of the total funding) and 144 FTE to meet the third goal—to ensure market integrity in order to foster open, competitive, and financially sound markets

The outcomes to be achieved as a result of the investment made related to this goal are that clearing organizations and firms holding customer funds have sound financial practices, commodity futures and options markets are effectively self-regulated, markets are free of trade practice abuses, and the regulatory environment is flexible and responsive to evolving market conditions.

How will the CFTC work to ensure zero loss of customer funds as a result of firms' failure to adhere to regulations and ensure that no customers are prevented from transferring funds from failing firms to sound firms?

What mechanisms does the CFTC have to monitor self-regulatory organizations to ensure that no funds are lost as a result of the failure of SRPs to comply with their rules?

Answer. Again, the Commission has several complementary programs that address the protection of customer funds held by FCMs) and derivatives clearing organizations ("DCOs"). They are summarized by staff below:

—*Protection of Customer Funds—Statute and Regulations.*—The Commodity Exchange Act and Commission regulations require each FCM to segregate from its own assets all money, securities or property deposited by customers to margin or secure futures and option on futures positions traded on designated contract markets or funds that accrue to customers from these open positions. Each FCM also must set aside in accounts (i.e., "secured accounts"), separate from its proprietary accounts, sufficient funds deposited by customers trading on non-United States futures markets to meet its obligations to customers trading on foreign markets.

—*Notification.*—Commission regulations also require each FCM to perform daily calculations demonstrating compliance with the segregation and secured amount requirements. Any FCM that does not maintain sufficient funds in segregated accounts or in secured accounts, as applicable, to meet its obligations to its customers (i.e., is "under segregated") is required to provide immediate telephone notice, confirmed immediately in writing, to the Commission and to the FCM's self-regulatory organization ("SRO") that conducts financial surveillance over the firm.

—*Commission and SRO Responsive Action (Direct Examinations).*—Upon receipt of a notice, Commission staff work with the applicable SRO to determine the facts and to assess whether the situation is a temporary under segregation that can be immediately rectified by the FCM infusing additional funds into segregated or secured accounts, or indicative of a more serious issue that may require prompt SRO or Commission action to protect customer funds. In certain situations, Commission and/or SRO staff may conduct an immediate onsite examination of the firm's books and records to assess the FCM's compliance with its financial requirements.

—*SRO Oversight.*—The Commission conducts periodic reviews of SROs' financial surveillance programs. The SROs' financial surveillance programs include routine examinations of FCMs to assess their compliance with Commission and SRO minimum financial requirements and related reporting requirements, including minimum capital requirements and compliance with the segregation and secured amount requirements. The Commission and SROs also may conduct an examination of an FCM on an exigent basis in response to an FCM filing a notice that it is not in compliance with the customer funds segregation or secured amount requirements. Experience has demonstrated that if the Commission and SROs can react promptly at the initial signs of weakness in the financial condition of an FCM, it is more certain that customer funds will be protected. In this regard, open futures and options on futures positions may be expeditiously transferred to another FCM if the FCM that is experiencing financial difficulties has properly segregated and secured customer funds.

—*Communication With SROs.*—Commission staff hold periodic meetings with the financial surveillance staff of the SROs for the purpose of discussing emerging issues and to coordinate examination procedures and policies. This includes an annual review of the detailed SRO audit programs, which are submitted to the Commission for review.

The resources requested by the Commission for the protection of customer funds would allow Commission staff to conduct more frequent assessment of the SROs' execution of their financial surveillance programs. Additional resources would also allow the Commission to conduct more frequent direct examinations of FCMs for compliance with financial and other requirements, including the segregation of customer funds.

—*Risk Surveillance Program.*—The Commission's risk surveillance and DCO review programs also serve to protect customer funds by (i) identifying traders that pose risks to firms and firms that pose risks to DCOs, and (ii) taking steps

to mitigate those risks thereby decreasing the likelihood of default. Additional resources would allow the Commission to enhance these programs.

Question. What are the advantages and disadvantages of "regulatory restructuring" from the perspective of the CFTC?

Answer. Exchange traded futures and options contracts are derivatives relied upon by the nation's businesses for price discovery and risk management. The CFTC's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets. Like exchange traded futures, OTC swaps and similar transactions are derivatives. Like futures, OTC derivatives are used for risk shifting purposes. In recent years the OTC market has grown to far exceed the exchange traded market in size. Bringing OTC dealers and markets under CFTC regulatory oversight will greatly enhance the ability of the Commission to fulfill its mission and to protect the price discovery and risk shifting functions of derivatives markets. Additionally, bringing the OTC dealers and markets under federal regulation will significantly improve financial integrity and transparency, qualities that were lacking in the collapse of firms like AIG and Lehman Brothers.

Question. Fourth Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$31.5 million (or 19 percent of the total funding) and 121 FTE to meet the first goal—to facilitate agency performance through organizational and managerial excellence, efficient use of resources, and effective mission support.

Among the outcomes to be achieved as a result of the investment made related to this goal are a productive, technically competent, competitively compensated and diverse workforce, a modern and secure information system, and an organizational infrastructure that effectively and efficiently responds to and anticipates both the routine and emergency business needs of the agency.

How does the CFTC intend to measure progress and the extent to which these outcomes have been achieved?

Answer. The Commission has developed 18 performance measures intended to measure progress in achieving the stated outcome objective. Of the 18 measures 11 results were determined to be effective, one was determined to be moderately effective, and six were determined to be adequate. The performance results along with an annual performance analysis and review are included in pages 91–110 of the Fiscal Year 2008 Performance and Accountability Report available on the CFTC Website at: www.cftc.gov/aboutthecftc/cftcreports.

QUESTION SUBMITTED BY SENATOR SUSAN COLLINS

Question. Excessive speculation in the commodities market is prohibited under CFTC's statutes. However, determining what constitutes excessive speculation is a thorny question. Last year, as oil and other commodities skyrocketed on the futures market, many in Congress became concerned that these market prices were more reflective of the activity of speculators than commercial interests in the underlying product. Last year, under the leadership of Chairman Lukken, the CFTC stated that despite the rapid increase in prices, the data did not reflect manipulation by speculators. Critics, however, contend that in this arena, the CFTC is simply outmatched. It lacks the manpower and resources to effectively collect the large volume of data in the commodities markets and to effectively analyze that data. Do you believe the CFTC needs more resources to gather relevant data and effectively analyze it to better understand the role and the effects of speculators?

Answer. The Commission examines markets by studying the behavior of commercial and non-commercial traders. In determining the status of traders, the Commission has traditionally accepted their self-classification. The Commission has begun to examine trader patterns to ascertain the general accuracy of these classifications. Commission assessments of the self-classifications are staff intensive and in order to accomplish them expeditiously and on a sustained basis, additional resources will be required.

On another front the Commission relies on market positions information that is updated daily. Without intraday position information, the Commission cannot examine any price effect occurring on the same day as a position change. This problem could be addressed were position information available throughout the trading day. Obtaining and processing such information will require additional resources for both staff and data processing capacity.

SUBCOMMITTEE RECESS

Senator DURBIN. Thank you very much for coming in.

Mr. GENSLER. Thank you, Mr. Chairman, Ranking Member Collins. Thank you so much.

Senator DURBIN. Thank you very much.

The subcommittee hearing is hereby recessed.

[Whereupon, at 12:27 p.m., Tuesday, June 2, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

REGULATORY REFORM AND THE DERIVATIVES MARKET

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
JUNE 4, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

54-570 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

PATRICK J. LEAHY, Vermont
KENT CONRAD, North Dakota
MAX BAUCUS, Montana
BLANCHE L. LINCOLN, Arkansas
DEBBIE A. STABENOW, Michigan
E. BENJAMIN NELSON, Nebraska
SHERROD BROWN, Ohio
ROBERT P. CASEY, Jr., Pennsylvania
AMY KLOBUCHAR, Minnesota
KIRSTEN GILLIBRAND, New York
MICHAEL BENNET, Colorado

SAXBY CHAMBLISS, Georgia
RICHARD G. LUGAR, Indiana
THAD COCHRAN, Mississippi
MITCH McCONNELL, Kentucky
PAT ROBERTS, Kansas
MIKE JOHANNIS, Nebraska
CHARLES E. GRASSLEY, Iowa
JOHN THUNE, South Dakota

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| Regulatory Reform and the Derivatives Market | 1 |

Thursday, June 4, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|---|
| Harkin, Hon. Tom, a U.S. Senator from the State of Iowa, Chairman, Committee on Agriculture, Nutrition, and Forestry | 1 |
| Chambliss, Hon. Saxby, a U.S. Senator from the State of Georgia | 3 |

Panel I

| | |
|---|---|
| Gensler, Gary, Chairman, Commodity Futures Trading Commission, Washington, DC | 7 |
|---|---|

Panel II

| | |
|--|----|
| Bookstaber, Richard, New York, New York | 34 |
| Dines, David, President, Cargill Risk Management, Hopkins, Minnesota | 36 |
| Driscoll, Daniel A., Executive Vice President and Chief Operating Officer, National Futures Association, Chicago, Illinois | 41 |
| Lenczowski, Mark, Managing Director, JPMorgan Chase & Co., Washington, DC | 31 |
| Masters, Michael W., Managing Member/Portfolio Manager, Masters Capital Management, LLC, St. Croix, U.S. Virgin Islands | 38 |
| Stout, Lynn A., Paul Hastings Professor of Corporate and Securities Law, University of California-Los Angeles, Los Angeles, California | 29 |

APPENDIX

| | |
|--|-----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 62 |
| Bookstaber, Richard | 64 |
| Dines, David | 71 |
| Driscoll, Daniel A. | 77 |
| Gensler, Gary | 80 |
| Lenczowski, Mark | 95 |
| Masters, Michael W. | 101 |
| Stout, Lynn A. | 131 |
| DOCUMENTS SUBMITTED FOR THE RECORD: | |
| Chambliss, Hon. Saxby: | |
| “Exchanges Warn On OTC Clearing”, article, <i>Financial Times</i> , June 3, 2009 | 138 |
| Dines, David: | |
| Chesapeake Energy, prepared statement | 139 |
| “The Role of Speculation in the Recent Commodity Price Boom (and Bust)” | 142 |
| Association for Financial Professionals, written statement | 177 |
| Commodity Markets Oversight Coalition, written statement | 179 |
| National Association of Manufacturers, written statement | 183 |

IV

| | Page |
|---|------|
| QUESTION AND ANSWER: | |
| Chambliss, Hon. Saxby: | |
| Written questions for Gary Gensler | 186 |
| Roberts, Hon. Pat: | |
| Written questions for Gary Gensler | 187 |
| Written questions for David Dines | 187 |
| Gensler, Gary: | |
| Written response to questions from Hon. Saxby Chambliss | 188 |
| Written response to questions from Hon. Pat Roberts | 189 |
| Dines, David: | |
| Written response to questions from Hon. Pat Roberts | 191 |

REGULATORY REFORM AND THE DERIVATIVES MARKET

Thursday, June 4, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 10:05 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Nelson, Casey, Klobuchar, Gillibrand, Bennet, Chambliss, Thune, and Johanns.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM THE STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman HARKIN. The Senate Committee on Agriculture, Nutrition, and Forestry will come to order regarding a hearing on regulatory reform in the derivatives markets.

Although we see hope in the strong economic recovery steps we have taken, we are still struggling through a grave economic downturn. The lack of sufficient regulatory authority and oversight regarding the financial markets is widely acknowledged as a key factor in the global economic crisis. It is not credible to assert that the markets and present regulatory system have worked. When the Federal Government has had to inject some \$4 trillion—\$4 trillion—into the system to stave off a total collapse of the economy.

Recent problems indicate the need for fundamental reform. Fundamental reform. The 2008 run-up in oil prices left our economy bruised, our Nation keenly aware of not only its dependence on foreign oil but the struggle with speculation in the markets. Volatile agricultural commodity prices, high input costs, and problems with the wheat and cotton markets have exposed vulnerabilities in our agriculture futures markets. But possibly the most problematic, our national economy has been held hostage by poorly regulated financial markets and the irresponsible behavior of some market participants, particularly when it comes to financial derivative products like credit default swaps and other over-the-counter derivatives.

I think it has become obvious that we must restore proper regulatory oversight if we are going to get this economy built on a solid foundation. Simply put, the derivatives markets must work properly and in the open. Agriculture futures markets are fundamental to the functioning of every aspect of our agriculture economy.

(1)

Financial services now account for about as much as 20 percent of our economy, and if those markets are not healthy or properly regulated, I think the evidence is clear our economy suffers.

Now, the Commodity Futures Trading Commission plays a vital role in providing oversight in keeping these players honest. If we do not invest in the regulators and the enforces to expand that oversight to the over-the-counter markets, I think we are going to continue to pay a heavy price.

It is imperative that we pass strong financial regulatory reform in this body and not just piecemeal, patchwork reform, but comprehensive and fundamental reform that brings full transportation and accountability back to the markets. Earlier this year, I introduced the Derivatives Trading Integrity Act; I think one I also introduced last year. The bill would require all futures contracts to trade on regulated exchanges. Why do I want that? Because exchange-traded contracts are subject to a level of transparency and oversight that is just not possible in over-the-counter markets.

For many years, derivative contracts have traded very efficiently and openly on regulated exchanges. But we have seen the damage done by moves to circumvent properly regulated derivatives trading.

I would also say it is not sufficient to assert, as many swap dealers do, that the market for credit default swaps function properly and has experienced no major problems during the current crisis. As conceived by derivatives traders in the mid-1990's at JPMorgan Chase—well, it was JP Morgan then—the CDS was designed to assist in the smooth functioning of the credit market and presumably to make it easier to raise capital by issuing corporate bonds to fund investment in the production of goods and services, which is what we want the financial sector to do. What is the end means of our financial services sector? That is for the production of goods and services to add to our GDP. Otherwise, you are just in a gambling game.

So the fact is it was going to make it easier to raise capital by issuing corporate bonds to fund investment in the production of goods and services. But the facts belie that claim. While the total face value of CDS contracts more than tripled—triple—between 2005 and 2008, the share of gross private domestic investment in U.S. GDP stagnated and then fell by more than 15 percent. That is at the end of 2008.

I have a chart. I wanted to see what it looked like, so I have a chart. So you see here the share of investment in U.S. GDP, and then here you have got on the red line the notional value of the CDSs.

Now, for a while, they seemed to track pretty well, but right here in about 2005, investment goes down and the value of the CDSs go up. So I think you can safely say they were not adding anything to the value of the goods and services of our country at some point in time.

Nor do I agree with those who assert that more rigorous regulation of these markets will discourage innovation or hamper our economy. Well, if financial innovation improves the ability of companies to hedge their risks or improves the functioning of the market, then the incentive for creativity will be there. But if the prime

motivation for innovation is to speculate, to avoid taxes, or assume reckless risks, the public has an interest in regulating that sort of "creativity."

I have often asked, Where was the market demand for credit default swaps? Where was the market demand for collateralized debt obligations? Where was the market demand for collateralized mortgage obligations? It was just sort of thought up.

You know, I have to digress here a second. I was just looking at the last issue of Newsweek magazine that has got Oprah on the front. I guess that sells the magazine. But it is called "The Revenge of the Nerd," and it is about the quants. How many people in this country know what a quant is and what they did in terms of speculation, through these mathematical geniuses that came from various and sundry place, how they devised these financial instruments to slice and dice and make money on things that really were not adding to the goods and services value of this country. It is a great article. I would recommend your reading it.

As I said, if that creativity is there just to add for speculation purposes and for sort of gambling and for high rollers and people making a lot of money in a short span of time, but not really adding to the sound investment in our country, then, quite frankly, I think the public has a big interest in regulating that kind of creativity.

So we must protect consumers and lower systemic risk and enhance the price discovery function of the markets, reduce excessive speculation, give the regulators the authority and information they need to keep the markets free of fraud and manipulation. In doing so, we will maximize the economic value of the derivatives markets by making sure they are structured to manage risk rather than to magnify it and guarantee that bad actors are held accountable.

So we have a lot of work to do on legislative reform. It is imperative that we all work together to come up with a solution that will bring transparency, accountability, and stability to our derivatives markets. So I welcome this hearing and this testimony. I thank each of the witnesses for coming here today, and I look forward to hearing their thoughts. I cannot think of anything that—well, this Committee has to do—we have to reauthorize the child nutrition bill later this year. We are going to work on that. But we have got to do this. This has got to be done this year.

I have talked with my colleague, my counterpart in the House, Chairman Peterson. He feels the same way. So I just do not think that we can push this off any longer. We have got to strengthen the hand of the Commodity Futures Trading Commission. We have got to give them the authority, and I am going to be asking the new Chairman about that and about any resources that they need. But we have got to get the CFTC the authority and the resources they need to do this kind of regulation and oversight.

With that, I will yield to my distinguished Ranking Member, my good friend, Saxby Chambliss.

**STATEMENT OF HON. SAXBY CHAMBLISS, A U.S. SENATOR
FROM THE STATE OF GEORGIA**

Senator CHAMBLISS. Well, thank you very much, Mr. Chairman, and you and I agree 100 percent that this is a critical issue, and

it is an issue that we have got to address and an issue that certainly calls for more regulatory measures, but I think regulatory measures that are not too intrusive to destroy markets rather than to continue to create and innovate in the markets. I know you had a conflict last night and were not able to be there, but we had a very good meeting with Secretary Geithner last night, along with our Senate Banking colleagues as well as our House Agriculture and Financial Services folks. We fully expect that the Secretary is going to come forward, I am sure with consultation of the new Chairman, with some recommendations in the next couple of weeks. We talked about some ideas that we have as policymakers there last night that are going to help influence, obviously, in a very strong way the direction in which the administration wants to go.

I am very confident that we are going to be able to come together with a very strong proposal that does make certain modifications that are not overburdensome, but yet at the same time will provide that protection that you referred to for all consumers as well as making sure that we have stability in the markets.

I do strongly believe that the Senate Agriculture Committee and the CFTC must be engaged in the development of any legislation addressing financial regulatory reform. This Committee has a responsibility to ensure proper oversight of the CFTC, and we must do more to fulfill this duty.

Today's hearing covers a wide range of issues: speculative trading in the commodities markets, changes to regulation of the over-the-counter derivatives, and the CFTC's authority over retail off-exchange transactions. Those are all worthy individually of hearings, and they are very complex issues that we are going to have to be dealing with in the legislative proposal that you alluded to and that I agree is going to have to come forward.

Among the most complex instruments, we have recently heard a great deal about credit default swaps, or CDS, which permit one party to transfer the credit risk of bonds or syndicated bank loans to another party. Given that AIG was heavily involved in CDS, it seems simple enough just to blame swaps in general for the current financial crisis. But, of course, it is much more complicated than that. Failing to distinguish between credit default swaps and the actual mortgage-related debt securities that these swaps were referencing has resulted in an oversimplification of the problem and subsequently an oversimplification of the proposed solutions.

Simply banning the use of all over-the-counter derivatives or forcing such contracts onto an exchange is unrealistic and unlikely to even address the underlying problem; that is, is this really a chance we are willing to take in these uncertain times, a chance that we would make things worse, dry up more capital, and force the cost of doing business higher?

Speaking of business functionally, curbing speculation in the physical commodity markets—speaking functionally, curbing speculation in the physical commodity markets is another area that we must approach very carefully. This is also not a simple topic. Determining how much speculation is necessary and how much speculation is excessive is an enormous challenge and something that we

will be talking with the Chairman as well as our other witnesses about this morning.

Some seem to have decided that all speculation is bad, but I would like to remind folks that without speculators in the marketplace, our farmers, ranchers, and energy users would find very little liquidity in these markets and would thereby not be able to utilize them effectively. Those individuals and businesses hedging risks and physical commodities, the parties that some claim they are trying to protect by running speculators from the market, are the ones who are likely to be hurt the most if speculative money dries up. I fear that this is another example in which oversimplification may be leading us to solutions of vast unintended consequences.

We must remember that during the past 18 months of bankruptcies, hailouts, and Government-assumed ownerships, the Nation's futures markets have functioned quite well. Price discovery has occurred, consumer funds have been protected, and there has not been a single bankruptcy of any clearing organization.

Does this mean there is not room for improvement? Of course not. Do I think the volatility in some markets over this lifetime warrants extensive analysis and possibly regulatory changes? Absolutely. While I may have concerns with some of the proposals that have been discussed relative to regulating both the use of over-the-counter derivatives and speculative trading, I am absolutely convinced that the market volatility and financial meltdown of the recent past make the case for more market transparency.

How can we in Congress gamble on the outcome of sweeping reforms without first properly identifying the cause of these problems? How can we identify the cause of the problem without authorizing and/or requiring more transparency through the collection of necessary data?

Yes, I have seen all the press accounts claiming the evils of indexed investments, swap dealers, and speculators, but what statistical data is used to support these claims? From what I can tell, many assumptions in the analysis to date are assumptions that may very well be accurate. But how do we verify this accuracy without access to the facts? Assumptions are simply not good enough when it comes to the responsibility Congress has to protect the integrity of these markets—integrity that would be compromised by lack of market liquidity or by increasing the cost of risk management or by forcing a migration of these markets overseas.

While I want to understand the causes that led us here, I do not believe anyone in this room—or anywhere else, frankly—has all the answers to what exactly went wrong. I am not willing to believe everything reported in the press unless the claims can be backed up with hard, verifiable data. To do otherwise is reckless. In fact, the data we have seen so far actually contradicts some of the claims people are so quick to believe and ultimately to blame for causing this mess that we are facing today.

Beyond requiring more transparency, I also believe this Committee should explore how most effectively to regulate swaps, some of which are statutorily excluded from CFTC regulation and oversight. We should review the manner in which hedge exemptions

from position limits are granted, and we need to determine how best to encourage the clearing of certain derivative products without jeopardizing either the use of these risk management tools or the sustainability of our clearinghouses.

If Congress is truly interested in addressing the problem as opposed to politicizing a solution, we can no longer ignore the complexities of these markets. We must devote time to understanding these instruments and their implications. We must seek to understand the legitimate purposes these complex instruments serve for large and small businesses in each of our States. That is why hearings such as this are absolutely essential. The last thing we should be doing is contributing a whole host of new, unappealing consequences in an already volatile marketplace.

Mr. Chairman, I particularly look forward today to hearing some of the practical aspects of utilization of these products that are on the market today, and I fully expect our witnesses to be able to tell us, No. 1, how they utilize them from the standpoint of making the economy of this country stronger by making their businesses stronger, and also how they think we can move in the direction of further regulation to ensure that confidence on the consumer side as well as stability and liquidity in the marketplace.

So, again, I thank you for bringing this matter forward. I know it will be the beginning of a dialog that fully recognizes the role of the CFTC but also that of the Agriculture Committee. I am very pleased that we have our new Chairman that we now have in place here to kick off this hearing this morning. Mr. Chairman, I say publicly congratulations and we are excited about you being where you are, and we look forward to working with you and hearing your testimony this morning.

Chairman HARKIN. Thank you very much, Senator Chambliss.

Now we will move to our witnesses, and first is our new Chairman of the Commodity Futures Trading Commission. Mr. Gary Gensler was sworn in as Chairman of the CFTC on May 26, 2009. Chairman Gensler previously served at the U.S. Department of the Treasury as Under Secretary of Domestic Finance and as Assistant Secretary for Financial Markets, subsequently served as a senior adviser to the Chairman of the U.S. Senate Banking Committee on the Sarbanes-Oxley Act reforming corporate responsibility, accounting, and securities laws. Chairman Gensler is the co-author of a book, "The Great Mutual Fund Trap"—which I just mentioned to him in private I have been reading parts of it, and I recommend it highly—which presents common-sense investment advice for middle-income Americans.

Mr. Gensler is a summa cum laude graduate from the University of Pennsylvania's Wharton School, with a Bachelor of Science in Economics, received a Master's of Business Administration from the Wharton School's graduate division in 1979.

Mr. Gensler, welcome back to the Committee. Congratulations again on your assumption of the chairmanship of the CFTC. Your statement will be made a part of the record in its entirety, and please proceed as you so desire.

**STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY
FUTURES TRADING COMMISSION, WASHINGTON, DC**

Mr. GENSLER. Mr. Chairman, Ranking Member Chambliss, members of the Committee, thank you for your unanimous support in my recent confirmation, and thank you for inviting me here today to talk about this critical issue to the Nation's economy.

I believe that we must urgently enact broad reforms to regulate the over-the-counter derivatives marketplace. Such reforms must comprehensively regulate both the derivative dealers—those institutions that make markets in these products—as well as the markets themselves. I think that it is very important for the future of our economy and the welfare of the American people, and I pledge to work with this Committee and Congress to try to restore confidence in the financial regulatory system.

Many of these reforms will require statutory changes, of course, but, Senators, please also know that I have already directed the Commission staff to present all options under our current and existing authorities to protect market integrity and consumers from price volatility—that price volatility that may accompany a rebound in this overall economy as well, as we move forward. This is particularly the case within the physical commodities, whether it is wheat, grain, or energy markets.

A comprehensive regulatory framework governing the over-the-counter derivatives markets and over-the-counter derivatives dealers should apply to all dealers and all derivatives, and I believe that it should not matter what type of derivative is traded. That would include interest rate products, currency products, commodity products, equities, as well as credit default swaps, or that which cannot be foreseen yet, and any other swap or derivative product coming in the future.

Furthermore, it should apply to dealers in derivatives no matter whether they are trading in standardized products or in customized products. In my written testimony, I go further into that. But let me mention the four key objectives that I think we would wish to achieve here.

One is to lower systemic risk. We have to make sure that there is less risk in the overall system. Two is promoting transparency and efficiency in markets. Three is promoting market integrity and preventing fraud, manipulation and other abuses, setting position limits where appropriate. Fourth, protecting the retail public.

To achieve this, I foresee working with Congress on two complementary regimes: through the dealers that hold themselves out to the public in these products, we should set capital standards to lower risk margin requirements as they conduct business directly with other commercial enterprises; business conduct standards, which I want to return to; and recordkeeping and reporting. This would be for all derivatives, whether customized or standardized, whether they be interest rate product or credit default swaps.

On the dealer community, there are really just 20 or 30 large dealers, the business conduct standards would protect against fraud, manipulation, and other abuses. The recordkeeping and reporting, importantly, would allow the regulators to see a complete picture and aggregate this picture.

In addition, I do believe, though, we need to regulate the markets as well. This is a complementary regime to bring the standardized products, those products that can be brought into clearing and brought onto exchanges, further lowers risk. Clearing has the attribute that no longer would the financial system be so interconnected. Individual firms, rather than having exposures to each other, would have the clearinghouse that has to have the discipline of daily mark-to-market and daily posting of collateral.

Regulated exchanges and transparent regulated trading facilities or trading platforms bring additional transparency, and what we are proposing—and I believe the administration letter also spoke to this—is that there would be a real-time reporting of those transactions of the standardized products. So the full market could see on a real-time basis, as they do in the corporate bond market and they do in the securities market, the pricing of the products as clearly as they can.

Before I close this oral part, I want to say there are two other things, I think, that we need to work together on beyond regulating the over-the-counter derivatives marketplace and fully bringing this under regulation.

I believe that we will need to work together on the appropriate authorities to put in place aggregate position limits over the marketplace, particularly as it relates to physical commodity products, but also that we need to address some abuses in the retail area. Last year's fix with regard to foreign exchange trading, I think that we will need to extend that to other physical commodities. We thank you for some of those helps in Congress. Furthermore, to have clearer authority for the CFTC to make sure that foreign boards of trade comply with our transparency and position limit authorities here, effectively in statute to close what is called "the London loophole."

With that quick summary of a very complex subject, I look forward to working with this Committee and taking your questions today.

[The prepared statement of Mr. Gensler can be found on page 80 in the appendix.]

Chairman HARKIN. Thank you very much, Chairman Gensler, and as I said, I read your testimony thoroughly last evening, and I just found it very enlightening, and like I said, I think I agree with most of everything you have put in there. I have some questions I will ask about a couple of parts of it here. But as you know, I have expressed to you privately and I have expressed publicly that I appreciate, first of all, that this is the unanimous position of the Commission, as I understand. Is that right?

Mr. GENSLER. That is correct. I am pleased to report the testimony represents a Commission document.

Chairman HARKIN. I would be remiss if I did not recognize one of your Commissioners who is here, Michael Dunn, and to thank him for serving as the Interim Chairman of the CFTC during this period of time. I want to thank you very much, Commissioner Dunn, for doing that yeoman's work in that interim chairmanship.

You and I, Mr. Gensler, I think, agree on the need to enact significant regulatory reform—significant regulatory reform—of the derivatives market. I do not know if this is a divergence or not in

our approach, but it has to do with over-the-counter derivatives and whether they should be allowed to continue.

If we do allow over-the-counter trading, then I think the requirements that you have proposed would be at least the minimum, I think, of what we should be doing in terms of ensuring the integrity of those markets. But I just want to explore with you again on the record in public whether we might move all of this activity to a regulated exchange or an electronic trading system.

So I want to discuss that with you, but, again, I also want to get into what resources you might need also. I will not get into that in detail, but at some point we have got to think about what kind of resources you might need.

But you propose establishing criteria for determining whether a derivative is standardized or not. Now, I wrote these down: whether a contract is accepted for clearing by a regulated clearinghouse, the volume, the look alike nature of the contract, evaluating whether the difference between the OTC contract and the exchange contract are significant economically, or if the contract terms are disseminated to third parties. A lot of details are left out of that.

I still ask the question, I ask you as I asked it of Mr. Geithner, not before us but in a meeting in the Capitol: Define a "customized swap." What is a "customized swap" that cannot be traded on a regulated exchange? I still am wrestling with that.

Mr. GENSLER. Mr. Chairman, I think that we share your concern that we need to bring a regulatory regime to the entire market, those standardized and those tailored products, and that is why we are proposing to regulate the dealer community and be able to get the full picture, the full recordkeeping and reporting, even with an audit trail, so that we can police and enforce anti-fraud and anti-manipulation provisions, enforce position limit authority.

In terms of your question, we believe that there are tens of thousands of commercial interests in this country that promote their business needs by hedging within the futures marketplace and hedging within the swaps or over-the-counter derivatives marketplace. We need to bring regulation to that marketplace.

Individual commercial interests and municipalities sometimes want to tailor a product—it might be a specific product that hedges their risk in the interest rate markets, but it might be on a different day, it might be a different month than a standard product. Or it may be in the physical commodity market where it is an airline that wants a certain grade of jet fuel delivered at a certain location on a certain date. It is so specific and commercially even confidential that there is no liquidity, there are not four other parties that would do that exact contract.

So what we are proposing is that would still be regulated, it would still be regulated with regard to this first regime, where the dealers that are transacting this business have to comply with anti-fraud, anti-manipulation, that have to report and record all of this. The regulators would see a picture of the entire marketplace and be able to police that entire marketplace.

That commercial enterprise would get the benefit of transparency because the standardized products—over half the market, though it is hard to estimate exact figures, but a significant part of the market is standardized—would be brought into exchanges and re-

ported on a real-time basis, so the commercial enterprises get the benefit. But they may still want to tailor some features to a specific date or location in my little example that I gave.

Chairman HARKIN. I am still going to continue to press this issue, and I will with the other witnesses who come up. Give me an example of a customized, over-the-counter derivative contract that is so customized that it cannot be put on a regulated exchange.

Now, I understand that it may cost a little bit more for them to do that. But I think to me, the cost of that may eat into their profits a little bit. But to me, the need for the public to know that and for others to know it, for price discovery and transparency, it may be for a specific jet fuel, but that may have repercussions on other aspects of the oil market that could happen, depending upon how big that contract is.

So when you do that, I just have a hard time understanding what is so customized that it cannot be put out there in that market.

Mr. GENSLER. Mr. Chairman, the same reason that you are suggesting is why we think that even the tailored or customized products should be reported to the regulators so that the regulators can report the aggregate positions and see even the customized, in this case the example of the jet fuel. An exchange generally needs parties on both sides to come with bids and offers, and so really the key here is how much interest in a tailored product might there be.

So we believe we have to bring regulation to the entire marketplace, including these tailored products, and that we must have regulation of the dealer side so that we can also allow for commercial enterprises to still hedge their very specific and unique risks. At the same time, the commercial enterprises would be protected against fraud and manipulation. Market integrity would be protected by aggregate position limits across the markets. The regulators would be able to police these markets with seeing a real audit trail and a record of tailored and standard products.

Chairman HARKIN. On page 4 of your testimony—and I marked it last night—it says, “These standards”—regarding over-the-counter contracts—“also should require adherence to position limits established by the CFTC on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.” But if these contracts then are needed for price discovery, if you need price discovery, as you say right there, that “affect a significant price discovery function,” wouldn’t the public interest require this price discovery to be on an open, properly regulated exchange and not on the over-the-counter exchange?

Mr. GENSLER. Our proposal is that anything that could get onto clearing, anything a clearinghouse would accept for clearing would be presumptively standard. So if a clearinghouse accepts it, it would be considered standard. We will have to have rules of governance for these clearinghouses, and we have called for these to be fully regulated clearinghouses. But anything that was accepted should be out there and be exactly what you say, Mr. Chairman, fully transparent to the public and also on exchanges and on these trading platforms.

Chairman HARKIN. Well, there is some concern about the clearinghouses are run basically by the banks and others. This is not an open exchange. So I am concerned about what your regulation would mean and how we find out, again, whether these over-the-counter derivatives are being regulated.

Mr. GENSLER. I think the Chairman raises a very good point. Right now the clearinghouses, of course, have come into being—and, fortunately, they have come into being. There are a number of them that have started out. But they are on a voluntary basis. So we are talking about working with this Committee and Congress on having mandatory and statutory provisions. Working together we should find the right balance on governance as well with regard to these clearinghouses so we do not have, as you highlight, some of the conflicts that may exist. We would want to guard against those in the governance features.

Chairman HARKIN. Well, we will follow up on that. That is pretty interesting.

I am sorry. I took almost 10 minutes, so I will recognize other people for 10 minutes rather than 5-minute rounds. This is a very intricate subject, and it takes a little time to develop.

Senator CHAMBLISS.

Senator CHAMBLISS. Well, thank you, Mr. Chairman, and you are right, it is certainly above my brain's capacity to understand all the complexities of this industry. While you raise a good issue relative to customized swaps and derivatives, I think we are going to have some testimony from some folks today that actually use them, and they can dwell on the details. But I am pleased, Mr. Chairman, that you recognize that there is going to be a need for some custom items and products as we move forward.

We talked about this last night with Secretary Geithner, too, and he is of the same belief. It is the folks that are in the business every day that have the understanding of this rather than those who deal with so many other things on a daily basis.

Mr. Chairman, I sent a letter to—and let me compliment Former Acting Chairman Dunn for his great work, now Commissioner Dunn. We are pleased that obviously you were where you were and you are where you are, because it is folks like you and the current Chairman that understand these issues.

But I sent a letter back in April regarding several different issues, and you handed me the response this morning, so I am kind of going off what you just handed me here. But, basically, when we talk about costs, there are obviously issues on the trade side relative to costs, and we will talk more about that. But there are going to be significant costs on your side from the standpoint of whatever legislation we come up with, making further demands on you.

One thing I appreciate you going into detail about is if we are going to establish position limits and if we are going to make it mandatory upon the Commission to oversee and regulate items such as position limits, you have said that given the substantial increase in the number of commodities that would be required to have Federal speculative position limits, staff estimates that at least 20 full-time equivalent positions would be necessary to review the expanded scope of Federal position limits, grant hedge exemp-

tions, collect reports from persons granted hedge exemptions, and monitor for violations.

In addition, you go on to respond to my letter by talking about the further extension and regulation of speculative limits to OTC contracts and that also would be very significant and would require at least 60 additional staff, plus we would need to upgrade the systems that you have in place today to be able to handle that. Ballpark, do you have any idea what kind of additional funding we are looking for your budget to try to do just these things, which I think there is general agreement that we have got to move in this direction?

Mr. GENSLER. Senator Chambliss, I thank you for the letter that was sent to my predecessor and that I was able to deliver the estimates. The Commodity Futures Trading Commission, I believe, even with the generous support of this Committee and Congress is still sorely underresourced. We are in total at about 510 people. We just got authority to move up to 572, which just brings us back to the staffing levels that were in place in 1999, 10 years ago.

The futures markets that we regulate have gone up five-fold. The complexity has gone up significantly. We have six times more contracts today. But it is not just the number of contracts. It is global. We have gone from open outcry to electronic trading. So hopefully we will be working together with you and the appropriators in trying to find a way to address these very real resource needs.

If we do go further, as your letter asked about sitting more position limits, we made estimates of 20 or 60 people; you had two alternatives. Rather than speaking off the cuff, if we can get back to you on an exact sort of dollar figure that assigns to those two numbers, we would be glad to do that as follow-up.

Senator CHAMBLISS. Sure. Well, I think there is going to be general agreement that we have got to make some changes, and we agree here that you are underresourced now. But we are not going to put additional obligations on you without providing you additional funding. We are simply going to have to do that. Irrespective of what amount of money we are talking about, if, in fact, CDS or whatever part of the commodities market contributed to the financial collapse last year, it is going to be a lot cheaper to fund you to regulate than it will be to go through another situation that we are trying to recover from now.

Mr. GENSLER. Senator, I fully agree with you on that, that it would be a good investment of taxpayer dollars to guard against these risks.

Senator CHAMBLISS. One thing that has been of real concern to me from the standpoint of putting additional regulations in place is the fact that we might stymie, No. 1, innovation on the part of bright minds in the marketplace that are thinking of additional products, not just for the sake of making money on the end of selling them but providing a real service to businesses across our country and allowing them to utilize the marketplace, again, to offset risk.

If we, No. 1, take all the risk out of that, then I think we are going to be hampering the markets more so than helping them. Second, if we put in overburdensome regulations, then there is going to be the tendency of those folks, whether they are in my

hometown of Moultrie, Georgia, or Atlanta or New York, to simply go overseas and carry out the same transaction, but yet on another market that may not be regulated in the way we are talking about.

One thing that came up in our discussion last night—and I will not expect you to be able to talk in depth, but I would like your comment about this—is that if we are going to make changes to our markets in order to make sure that the same protections are in place for American consumers on overseas markets, then we need to go to our overseas markets, and we need to tell the Europeans that these are the changes we are going to make, and we hope you would look at the same type of regulatory process to try to coordinate and let us do not be overburdensome, but yet make the necessary changes so that our customers—or, excuse me, U.S. firm customers do not immediately go overseas and we lose that business and that ability to regulate those markets.

Any comments you have on the potential for that?

Mr. GENSLER. Senator, I think it is absolutely critical that we coordinate internationally with other regulators around the globe. Just yesterday, I actually met with the head of the European Commission on Internal Market and Services, Charlie McGreevy, on these matters. It was fortunate he was in town. But I know that Secretary Geithner and others are doing this. Commissioner Dunn is actually going overseas next week to take on some of this as well.

We need to coordinate and make sure there is not a race to the bottom somewhere else. I am encouraged by my meeting yesterday on that. I do think that we also have to really think about how we protect the American public and make sure that we get the right things in place there.

We need to not only allow but foster innovation so that the economy can grow but protect against risks, and the risks that we are talking about protecting against are the risk of fraud, the risk of manipulation, the risk that sometimes from speculation that becomes excessive speculation there may be burdens in terms of the volatility of markets. We are talking about protecting against the risk of unregulated actors like the affiliate of AIG, AIG Financial Products, that did not have any effective Federal regulation growing so large and being so excessively leveraged.

So while this is a complex proposal, regulating the dealers to lower risk, that means there is some capital. That means there is more cushion in the business that they have in their business model. That more capital may, as you suggest, lead to some more cost, but still allow for innovation, still allow fully for innovation, but lower the leverage in the system. I think one of the great lessons of the crisis of last year is the system overall, the financial system, got highly leveraged and too leveraged. Almost all the statistics will point to that.

So capital regimes and margin regimes lower risk; business conduct regimes lower the risk of fraud, manipulation, and the burdens of excessive speculation, but while still fostering innovation, fostering, as we have said in this approach, the allowance of tailored or customized products. So commercial interests can still hedge their risks.

Senator CHAMBLISS. I agree with you that certainly posting more capital is going to lower the risk, and I will not get you to go into any more detail than that because the other witnesses I expect will be able to give us some more information relative to that. But I want to make sure that we do not require too much in the way of reduction of risk that we just suck too much capital out of the marketplace and that we make sure that these folks that are utilizing whether it is over-the-counter or non-regulated today, that they still have the capital to operate their businesses in the way that they need to be operated.

I thank you, and I have got some more questions, but, Mr. Chairman, I will wait until the next round.

Chairman HARKIN. Thank you very much, Senator Chambliss.

The principle here we go on is time of arrival. Senator Casey was next, but he is not here right now. Then we will turn to Senator Johanns.

Senator JOHANNNS. Thank you, Mr. Chairman.

If I could maybe start out and do a little self-education here, because it is a hugely complicated topic we are talking about. But as I understand where you are kind of getting to here is, on the one hand, there is a set of regulations or an approach that you would like to be empowered to take relative to people or the companies that actually do business here. As I read the four items that you have mentioned, that really would deal with those dealers. Are we on the same page so far?

Mr. GENSLER. Yes, the dealers of which there are internationally maybe 20 or 30 large ones, they are out in the public domain, and by and large we know the names of those big financial institutions.

Senator JOHANNNS. Pretty straightforward working with them and laying out what the standards are going to be and the transparency and the capital that you have mentioned. So that for me is fairly understandable and fairly straightforward.

The second piece of this, though, I think it is really complicated, and that deals with regulation of products. How are you going to handle that, and what kind of authority do you want?

The first question I need to try to get an understanding about is as we look back over the last 8 to 10 to 12 months, if you were to identify the products that really were at the heart of the problem relative to the financial crisis, the AIGs, et cetera, what would those products have been?

Mr. GENSLER. Senator, I think that there are many factors that led to this economic and financial crisis, and only some of that was related to the products, because I do believe a great deal had to do with the excess leverage and excess borrowing and imbalances in the system overall. But in terms of specific products, I believe that the over-the-counter derivatives markets was a contributing factor, particularly with regard to credit default swaps explicitly. I think other products, if I can speak more expansively also, mortgage products specifically, the sales practices, and I think many homeowners and the retail public, often was misled, and even fraud in terms of the sale of those products, usually in the subprime market, but not always.

I think the securitized products, whether it is, as the Chairman mentioned, things called collateralized debt obligations and other

very sophisticated products there that are not specific discussions of this hearing today, because those are actually securities, and those are actually already regulated by the SEC.

I do believe the second regime is about bringing regulation to the markets, if I can use a term, rather than products. So it is bringing centralized clearing and a benefit of lowering risk that all of these derivatives or swaps come into a central counterparty and no longer is this interconnected web, but we try to have institutions use that central counterparty.

Some people say that we have had a system of too big to fail, but actually we have grown into a system that is also too interconnected to fail. So the central clearing is trying to make these counterparties less interconnected. You can think of it being less caught in a spider's web. The American public was caught in a spider's web of interconnected relationships last fall, and we should try to lower that as far as possible as we go and bring transparency to the exchanges.

Senator JOHANNIS. As I look at some of what happened—and you are right, gosh, picking out one thing is just not going to get you to an accurate viewpoint of what happened. But if I look at this—and hindsight is also 20/20. The amount of bad judgment exercised by people paid enormous amounts of money in salaries and bonuses is kind of breathtaking to me. How will what you are proposing protect the public from the exercise of that bad judgment?

Mr. GENSLER. Senator, I concur with you that there is a lot of bad judgment that went around. I think that at the heart, the way we protect the American public is having strict ability and clear, independent ability to protect the public against fraud and manipulation and the burdens that can come from excess speculation but also by putting in place this very real risk reduction, the capital and margin requirements both of the dealers and of the markets.

The American public should not be so at risk—they were terribly exposed by unregulated companies. AIG Financial Products basically was not regulated at the Federal level. Lehman Brothers and Bear Stearns derivative affiliates, basically lightly regulated at all at the Federal level. So we have to protect the American public. I believe this program, if enacted by Congress, would significantly do that with regard to over-the-counter derivatives. Certainly we need to do more about mortgage sales and some of these other areas that we talked about.

Senator JOHANNIS. Using AIG as an example, because what has happened to them is so very, very public, it was shocking to me to find out that they had this enormous risk exposure and basically no protect. If this thing started to implode, it was going to risk the viability of that entire company. You would have thought somebody would have paid attention.

If what you want to achieve here is accomplished, we give you the authorities that you are seeking, how would that have changed the situation with AIG, or would it have?

Mr. GENSLER. Well, I think that if these authorities were in place, and not just for this agency, the CFTC, but broadly, because of some of these authorities would be whether they be in a systemic regulator or elsewhere, to set capital, for instance—then AIG's Financial Products affiliate that did have, as you said—it was about

\$480 billion of credit default swaps. They would have had to have set capital to the side. They would have had to on a daily basis put aside margin and value those contracts. So as those contracts were going the other way, they would have been regulated.

I also think that while we have not studied it at the CFTC because we do not have any authorities over those products right now, but if you really look how the products were used and marketed, there is really in my mind some significant question about how they were marketed. They were largely marketed to lower capital standards in Europe and to be related to the products the Chairman talked about earlier, these collateralized debt obligations.

I think the credit default swaps have such unique features—a little bit like monoline insurance, a little bit like securities, they are certainly derivatives—that we are going to have to work together as regulators and with Congress to find some clear authorities on the trade practices with regard to credit default swaps.

Senator JOHANNIS. Thank you.

Mr. Chairman, thank you very much.

Chairman HARKIN. Thank you very much, Senator Johannis. That was an excellent question. That last one was great.

Senator Thune.

Senator THUNE. Thank you, Mr. Chairman. Thanks for holding the hearing. Chairman Gensler, thank you for being here. You are at the center of this storm and the historic run-up in commodity prices and oil prices last year that sort of caught everybody looking at how do we solve this, how do we prevent this in the future. It seems to me that the question is there clearly needs to be some kind of reform of the regulatory system that we have in this country with respect to a lot of these financial products that were sort of outside the realm of regulation. I guess the question is; how do we do this, what is the smart regulation? I am not someone who advocates regulation for regulation's sake. I think we have to think about how do we do this in a smart way, and it comes down to the fundamental question, in my view; how do we constrain risk?

It seems to me there are a number of ways that you could do that. You could have an exchange where there is more transparency and more accountability and where more of these transactions occur in the light of day. I think what happened was there was a lot of stuff that was going on in the dark.

Second, maybe it is in the form of margin requirements or capital standards, some of the things that you have alluded to, but I think we have to figure out how do we do that in a way that is responsible, that is smart, that gets at the heart of this problem, but does not push a lot of that capital to foreign exchanges, that does not create such an economic burden for a lot of the folks who are making markets in this country that they decide to go somewhere else to do it.

I think in order to make this work, it is critical, back to Senator Chambliss' questions, that we have international cooperation. So I guess my question is; how do we ensure that foreign exchanges are going to follow suit with the additional oversight and transparency regulations, specifically how do we go about doing that?

Mr. GENSLER. Senator, I share your view that this is about limiting risk, as you say, both in terms of the excess risk that you can limit through the capital and margin regimes, but also risks to the American public through protecting against fraud, manipulation, and other abuses.

I also share your view that we are going to need to and want to work with international regulators to see that there is not an arbitrage, meaning that people would go somewhere else rather than in these markets to avoid regulation.

I am encouraged by some of the initial conversations that I have had in my 8 days on the job. But I think that working with, the Chairman of the Federal Reserve and the Secretary of the Treasury, we are really going to have to work actively with our international colleagues to see that we can bring these reforms globally, and where there may be differences—because inevitably they have different political processes and legislative processes and regulatory processes—that we guard against those differences, not doing exactly what you said.

Senator THUNE. You have said throughout your testimony, you stressed the importance of protecting market participants from excessive speculation. I guess I am curious to sort of know how you define “excessive speculation.” We talked about the need for producers in States like Iowa and South Dakota to manage their risk. They use these markets for that purpose. But obviously speculation plays a role and did play a role, I think, in the problems that we encountered a year ago.

How do you define that, how do you get your arms around excessive speculation versus legitimate speculation?

Mr. GENSLER. The Senator asks a very good question. I share your view that financial investors, index funds, contributed and participated in the asset bubble of last year. I am concerned that as the good news of an economy that rebounds—and we hope, we all want this economy to rebound, that we might see a resurgence of these commodity prices. That is why I have already directed staff to really lay out for me as Chairman and for the Commission all the options that are available under current authorities to guard against this.

You know, Congress in the 1930’s, I believe, when they set up our predecessor, really best defined that. They said that there could be burdens to interstate commerce that come from excessive speculation, and Congress wrote into our statute that this could be unreasonable price fluctuations or the volatility that do not bear—I cannot remember the exact statutory words, but resemblance to the fundamentals.

Then Congress gave the Commission authorities to set position limits, and so it is through position limits that we try to guard against this, and we have actively used it over this time period.

Senator THUNE. Some have suggested that the CFTC and SEC ought to be merged into one regulatory body. What is your view on that?

Mr. GENSLER. Senator, I think whether we could have a debate here for a few days on what was the lead cause of this financial crisis, and I do not think any of us would put on the list that is near—I think we really have to focus for the American public on

lessons learned from this crisis, whether it is selling this product or this risk. So a merger for merger said to me while I think it will always be out there in the ether and be debated and discussed is not appropriate. I think we have a heavy agenda here working with Congress. Now, if somebody laid out why—if Congress and the President laid out why that would really help the American public, we would all want to work with that. But I do not see it really in the lead here of the reasons, and I do not think it is going to accomplish much for the American public today.

Senator THUNE. You got into a discussion earlier with the Chairman—and I think maybe with Senator Chambliss, too—about this distinction between standardized derivatives, customized derivatives, tailored derivatives, and the importance of having the ability for participants who enter into some sort of a customized association, that there would be a different way of regulating those. I guess the question comes back to is there a way of creating an exchange where these transactions could all be sort of managed in a way that is open and that is transparent and that allows for the public to be able to know what the pricing is and everything else.

What I heard you say was that you think it would be difficult to have that kind of a standardized—to create the sort of standardization of these products that would allow for them to be traded on some sort of an exchange, did I hear you correctly?

Mr. GENSLER. Well, Senator, I think that we can bring regulation—and it would be the identical regulation—to both tailored products and standardized products, identical regulation about protecting against fraud and manipulation, identical in terms of the capital charges of the dealer community, and we can even apply margin to both tailored products and standardized. The standardized products could have the margin through clearinghouses, and the tailored products could have it through the dealer community.

So I think actually it is a broad and very full regulatory regime—in fact, the same for tailored and standardized. What we need to encourage is much of the standardized product to be on centralized clearing because that continues to lower risk, and as much as possible onto exchanges or trading platforms, because that is an additional level of transparency, in addition to the transparency that the regulators will see it on, will aggregate it for the public, but additionally the standardized product, then you can see the real-time pricing.

It is a challenge. It is just a practical challenge. If it is tailored, you could put it on an exchange, and there would not be another party on the other side maybe. There might not be what is called a bid and an offer. So it is just a challenge. If we could do it, that additional transparency is helpful.

Senator THUNE. Well, I guess the bottom line is the transparency issue and price discovery, however those are regulated going into the future, that those elements be a part of any solution. So we look forward to working with you on this. Obviously, this is—it is a complex subject and one that many of us are trying to wrap our brains and arms around, and we appreciate your being here today and look forward to the testimony.

Mr. GENSLER. Senator, I thank you, and I look forward to working with you because I know these things are critical to your con-

stituents. We have to get everything to work in the wheat markets and the grain markets as well, and I know that has been a challenge, too, and we have got to focus on that.

Senator THUNE. I appreciate it.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Thune.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you very much for holding this hearing and for your persistence on all of these issues.

Mr. Chairman, welcome. It is nice to see you. I enjoyed reading your testimony. I wanted to focus on something that you have touched on lightly in some of your responses to the panel, because I think that the issues of the products, the issues of fraud, transparency, and all of that are important, and we need to make sure that we are doing a good job with these tough issues.

If you look back at where we are today and the cause of where we are, I think it is impossible to avoid coming to the conclusion that what ailed us most was the amount of leverage in our system. From the consumer level, if you look at credit card debt and home mortgage loans, to the Federal Government which doubled its national debt, to financial institutions on Wall Street that went from being 12 times levered to being 30 times levered over a period of time, you cannot sustain that unless you assume that you are going to have a hockey stick of growth for the rest of our lives—which is not going to happen.

I was struck in Lynn Stout's testimony—Professor Stout is here—when she wrote that her research indicated that the only time a significant U.S. derivatives market has not been subject to regulation was during the 8 years following the passage of the Commodity Futures Modernization Act of 2000. I was struck by that because I wondered as I read it how much that deregulation was a cause of the sheer volume of leverage in the market, because people were able to go out and create instruments, or whether they are unrelated. I wonder if you had a view on that.

Mr. GENSLER. Senator, I think you are correct that leverage in the American economy is one of the big causes of the crisis. If you just look at the overall statistics, it is remarkable, and I will just use it to summarize it. But through much of all of our lives, the economy has had a debt of about 1-1/2 to 2 times its economy. So it is like a household that might have a \$50,000 income and have \$75,000 to \$100,000 of debt.

We got up to about four times, about 4 to 1, and coincidentally, the last time we did that was in the late 1920's, the last time we got to that. These are the statistics published by the Federal Reserve on a quarterly basis.

I think that over-the-counter derivatives were a way that financial institutions—not the homeowners, but the financial institutions—add to their leverage as well, and that the capital and so forth were not charged there, and though I believe—looking back now it is clear to me that those of us involved earlier—and I served earlier—should have done more to protect the American public. Over-the-counter derivatives actually were not regulated even before that act passed in any way, for capital or for business conduct.

So what we are really talking about today, and working with Congress, is a full shift, because just as in the 1930's when President Roosevelt came to Congress and said we had to regulate the commodities markets and the securities markets for the first time, we are talking about—the CFTC, and I believe this is consistent with the administration, is talking about now coming and let's do this in a thoughtful but in a full way to regulate this market.

Senator BENNET. As you think about the systemic risk question, moving from a world where all of our regulation—that may be an overstatement—much of our regulation and all of our deregulation was, in effect, procyclical, was pushing us farther and farther and farther along this curve. How do imagine what you are proposing here will work with some of the suggestions that have been made by the administration, by the Fed, about where to locate the regulator of systemic risk? How will all these pieces fit together—your work, the Fed, the FDIC, the SEC? Because I think only if we have some way of looking at how these pieces fit together will we ever get the big picture. We can do it product by product by product, but really there is this big fundamental piece of not wanting to put ourselves in a position again where we simply have too much leverage on the economy and then have to go through an incredibly agonizing contraction, which is where we are today.

Mr. GENSLER. Right, right. I think that you are absolutely right, that we have had a lot of failures in our financial regulatory system; it failed the American public in the biggest test in 80 years. We have to address far more than just this over-the-counter derivatives marketplace, and part of that, as you say, Senator, is to have a systemic regulator, to have some ability for those largest systemically relevant institutions, those institutions that could make the public hurt so much, to have additional oversight.

I know that there are various approaches to it. What I would associate at least myself—I am not speaking for the Commission now, but just as Chair—is that we absolutely need this in working with Congress to make sure that it has clear authorities on those most systemically relevant. Those authorities might just be additional authorities.

So, for instance, where the CFTC is regulating markets and regulating clearing institutions and so forth, as a market regulator, I think in this country, again, since President Roosevelt and Congress worked together in the 1930's, market regulators have had their mandate, both the SEC and the CFTC, and that was a really important mandate, protecting the public, protecting the integrity of these markets, but then we would have a systemic regulator of some sort that we would have to coordinate.

Senator BENNET. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Bennet.

Now we go to Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman. Thank you for holding this hearing.

Mr. Chairman, it is nice to have you before us. I enjoyed our conversation earlier this year. I am interested in how we can find a way to regulate leverage, because leverage seems to be the operative word when you look at what happened with AIG. There was not a lack of leverage in their insurance operating subsidiaries be-

cause they are required by law and practice to put up reserves or capital against the commitments they made. But through the deregulation of 1988, I believe, with the decline of Glass-Steagall, with Gramm-Leach-Bliley, there was an effort then to be able to do as you chose at the top outside of the insurance operating subsidiaries.

Would you agree with that generally?

Mr. GENSLER. Senator Nelson, I believe with regard to AIG, they were regulated at the State level as an insurance company.

Senator NELSON. Exactly.

Mr. GENSLER. This has been a challenge, I know, for decades actually, and the Congress will probably want to take up in thinking about those systemically relevant firms, what if they are insurance companies and the relationship of Federal regulation to State regulation of insurance companies.

So I believe that AIG was sort of a case where there was an unregulated affiliate of an insurance company that was regulated at the State level. That unregulated affiliate, then it was sort of "Katy, bar the door."

Senator NELSON. Yes, and, in fact, the deregulation permitted this operation that was not regulated to do whatever it chose to do without setting aside capital to support the obligations it incurred.

Mr. GENSLER. Senator, I think that as it relates to AIG, which was not under any—in the 1980's, as you referred, not under, I believe back then, any Federal oversight. Later there was some, I would say, ineffective Federal oversight by the thrift supervisor. So I do not—I think really that it was an unregulated affiliate of an insurance company, and we have to make sure that going forward we regulate these derivative dealers, whether they are affiliated with an insurance company, whether they are affiliated with a hedge fund, affiliated with anything, if we are able to work with Congress and get this through.

Senator NELSON. Right, but that does not extend that somehow the Federal Government has to begin the process of regulating the insurance operating subsidiaries that are currently regulated by the States.

Mr. GENSLER. Not in this testimony or in my view. It is about trying to make sure that the derivative dealers come under a consistent regulatory oversight.

Senator NELSON. If they had the set-aside capital actuarially or in some fashion to support the obligations they were incurring, this would have been less likely to have happened the way that it has happened throughout the industry. Is that fair?

Mr. GENSLER. I think that is correct, Senator.

Senator NELSON. So establishing a way to require that capital will reduce the leverage that exists not only today but in the future as well. Is that fair, too?

Mr. GENSLER. I believe that is correct. I think to lower the leverage is setting those capital standards for the dealers, but also having margin posted, just as it is on a futures exchange. This has worked for decades in the futures exchange. There are problems even in regulated futures, but not about the capital and margining.

Senator NELSON. This was not related necessarily in every case to fraud, but in almost every instance you could say there certainly was some greed.

Mr. GENSLER. Well, I think that was the case broadly in this economic crisis.

Senator NELSON. I hope, as you look to regulate the tailored products as well as the standardized products, that there will be a system established to figure out the ratio for leverage against the obligations that are made. Do you believe you will be able to determine what the obligation is under tailored products?

Mr. GENSLER. I think, Senator, you raise a very good question, because one of the things about tailored products is they tend to be less liquid. They are sometimes harder to value.

Senator NELSON. There may or may not be much of a market for them.

Mr. GENSLER. There may not be much of a market, as the Chairman was talking about. I do think it is appropriate to take into consideration as regulators that if they are less liquid and they are tailored, that might lead to higher capital charges, just as any product that is less liquid and harder to value, because capital is meant to be a cushion against the risk if a firm fails or there are problems in the system.

So liquidity is a key, and just as the Chairman was talking earlier about whether the tailored products would be regulated, they would be consistently regulated; but if they are less liquid, it may be appropriate that the regulators say, well, you have to put a little bit more cushion aside on that.

Senator NELSON. Would you do this in the same way, let us say, that the National Association of Insurance Commissioners, which I used to head in a previous life, the way they do it through the Securities Valuation Office in New York that is part of the NAIC?

Mr. GENSLER. Senator, I dare say you are far more familiar with how that works. I am not familiar with the specifics there.

Senator NELSON. Well, they do value securities that do not have a market value based on one of the markets; in other words, private placements and the like. So tailored securities probably as much as standardized securities would fit into that sort of a category, where analysts would work their way through establishing what the leverage is, and then establishing capital requirements for that leverage.

Mr. GENSLER. I think, though I am not familiar with the specifics of that, I think that there should be consistently applied capital rules for the over-the-counter derivatives. Those that are on markets and those that are liquid, just like other products, the more liquid a product is, then—

Senator NELSON. The easier to value.

Mr. GENSLER. Easier to value, and it may necessitate a little less cushion, a little less margin. Certainly even in the futures markets right now there are different margins depending upon the volatility and liquidity.

I think one of the great lessons of this crisis is I believe that our overall capital regimes—and this is not within the CFTC, but our overall capital regimes let the American public down, and that we need to take, as Federal regulators, a closer look at those capital

regimes and make sure that they take into consideration particularly the less liquid instruments like collateralized debt obligations or structured product. Maybe they should have higher cushions or higher capital, and those that are easier to value, that are liquid instruments—

Senator NELSON. But you will have to have some mechanism, some way of—an analysis of establishing those values in an objective fashion, and I suppose you are going to be bothered by those that turn over too quickly to value them for any length of time, because you had them, they are gone, they have been sold. I just hope that you will find a way to consistently do that so that there is some objectivity and some reliability for establishing what the leverage requirements would be.

Mr. GENSLER. Right. Thank you, Senator.

Senator NELSON. Thank you, Mr. Chairman.

Mr. GENSLER. I thank you for your support.

Chairman HARKIN. Thank you, Senator Nelson.

Senator Gillibrand.

Senator GILLIBRAND. Thank you, Mr. Chairman, for holding this hearing, and thank you, Chairman Gensler, for being here and for testifying. These are very important issues. Few, if any, cities in the country have really felt the effects of the economic collapse more acutely than New York, New York City, the State that I represent. I want to talk to you a bit about how we can move forward so that we can create confidence in our markets and create a regulatory framework that will ensure success not only with the U.S. financial services industry but our economy overall, because we really do need to address the 8.5-percent employment rate nationwide, and we have to make sure our small businesses have the resources they need to grow and create jobs.

As we work to sustain the companies that form the backbone of our financial industry, we must ensure that the structures and the regulatory framework institute proper oversight and capital requirements while still promoting significant growth and expansion.

There has been a tremendous focus on the extraordinary losses that have resulted from the unregulated derivatives market, in particular the credit default swap markets, and rightly so. However, there also needs to be now significant attention paid to the regulation of these financial instruments, which have become an integral part of our financial system. We have to ensure that capital reporting requirements will allow derivatives to exist for legitimate participants, but discourage excessive speculation and protect our investors.

It is essential that we fully understand the implications on the end users, such as industrial companies who rely on derivatives to hedge commodity prices, interest rates, and foreign exchange rates. We must have an efficient and effective regulatory structure to ensure a vibrant economy, economic growth, adequate liquidity, and appropriate oversight and accountability.

So I first want to talk about what do you think and how do we allow legitimate participants versus those who are trying to game the system, and what sort of capital reporting requirements would allow custom derivatives to exist for legitimate purposes and par-

ticipants, but would discourage the excessive speculation and still be able to protect our investors.

Mr. GENSLER. Senator, if I might first start with thanking you for your support of my recent confirmation, and it is good to meet you. I lived in New York for 15 years. My three daughters were born in New York. Though I live in Maryland now, I have great affection and affinity for your State.

I think it is important to bring, as you say, greater regulation to this whole over-the-counter derivatives marketplace. I think we should best do that in two complementary regimes that would address, as you say, the legitimate interest of commercial parties to hedge their risks, but also have capital standards to lower the risk.

One is to have a regulatory regime of the dealer community—many that are in your great State—but of the dealer community so that those dealers have to have the capital to lower risk, to set margin, but also have business conduct standards to protect against fraud and manipulation. That regime covering the dealers would cover both standardized and tailored product. Tailored product or customized product would be allowed, but it would cover both of these as well.

I think that it is important, as you say, that commercial users have legitimate needs to do that, but we would want to bring as much of this product into centralized clearing and regulate the markets as well for that centralized clearing, because additionally that lowers risk. If we can lower risk through centralized clearing, that frees up capital in the dealer community, because if they can move product over to centralized clearing, that is a way to lower risk.

It also helps raise transparency to put that on exchanges where it is standardized product, and we would want to work with Congress to get this. So the presumption was if it could be on a centralized clearing, it could be on an exchange, we would do that.

Senator GILLIBRAND. What do you see at the upsides or downsides for actually requiring it to be on an exchange as opposed to just having it go through clearing?

Mr. GENSLER. We think that there are real benefits to also having it on an exchange. Of course, one of the features of our market system here in the U.S. is transparency, and the transparency of markets promotes economic efficiency. So we would have transparency by having information on 100 percent of the product, both tailored and standardized, available to the regulators. Making transactions available to the public lowers, we believe, some of the cost to the end users that you spoke about.

So bringing the standardized product onto exchanges means that any commercial user can see, Aha, 15 minutes ago, this is where—it might just be an interest rate swap, a standard product to hedge an interest rate for 5 years. They can see where that was. If you are a small hospital or municipality, you can say, Aha, that is where the pricing is and we should do the same.

Senator GILLIBRAND. But if you do require exchange trading, then you are really not going to have an opportunity for customized derivatives. So do you think you are going to lose enormous markets to overseas markets because you cannot accommodate that here?

Mr. GENSLER. Senator, we actually foresee that this approach would allow for, as you call it, customized or tailored product. Much of the derivatives marketplace right now is standardized, but there is still a very real need for end users to tailor their products.

So what we are calling for is 100 percent of the product, tailored and customized would be regulated through regulating the dealers. The product that could be brought onto exchanges would benefit because it would add transparency, but we would still foresee that end users would be allowed to tailor their needs. They might have a risk. I used earlier an example; it could be an airline that has a risk around a particular jet fuel to be delivered on a particular date in a particular location, that we would still allow for that, but still regulate and protect against fraud and manipulation and that the regulators would see it aggregated and publicly report the aggregated data.

Senator GILLIBRAND. I would like to turn specifically to one industry area, the trading of carbon permits, and the derivative products that may be based on them, and this may obviously become a major growth center for these markets.

How would these proposals affect the shape and the nature of carbon trading markets? Does the potential market for carbon derivatives have unique needs from other derivative products? What unique skills might the CFTC or another regulator need to effectively regulate this market?

Mr. GENSLER. Senator, I think that the CFTC has over many years developed a skill set and has a mission to oversee the derivatives marketplace, which we have called the "futures marketplace" for these years. In fact, there is already a small market in these permits or similar markets in Chicago called the Chicago Climate Exchange. There was a similar market that came up, oh, I think it is over 20 years ago now, out of some of the permits that came out of acid rain legislation of Congress.

As Congress moves forward and possibly further develops this, I would look forward to working with you and the Congress on how to get this right. But I think it would be important to protect against the same thing we protect against in the futures markets—fraud and manipulation. We should have the authority to set position limits, because these would be physically limited, these contracts would have a limited supply. So, again, hopefully bringing the same transparency and protections that we have currently to the futures markets.

Senator GILLIBRAND. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you very much, Senator Gillibrand.

Now we will turn to Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much.

Mr. Gensler, you have had a long morning. It looks like I am the last one here for you. I just wanted to thank you again, and I am glad that you are joining us. I think I expressed my frustration last time at your predecessor when I asked about more tools that he could have in his job. He did not seem interested, and yet we saw at the time oil prices going up, due in part to speculation and other problems with the regulation of the market. I do believe—I appreciate what you said about transparency and that we need to also take steps to minimize speculation when it is done not to benefit

consumers or the market, but instead to benefit a certain small segment of those that are doing the trading.

We need an effective CFTC, and then we also need to do something about some of these instruments, financial instruments that cause some of this problem. Specifically, when I talked with you during your confirmation hearing, we talked about credit default swaps. Now that it is a little calmer here, I wondered if you could talk about what you think needs to be done to better regulate credit default swaps.

Mr. GENSLER. Senator, again, thank you for your support in my confirmation process.

I believe that we need to bring regulation to the entire over-the-counter derivatives marketplace, so credit default swaps but also the interest rate product, currency swaps, commodity swaps that this Committee certainly has talked a lot about in the last 2 years, and equity products.

I believe that we can best do that, as I was just saying with the Senator from New York, that we have a regime to regulate the dealers. There are internationally maybe 20 or 30 major dealers. I do not mean to limit them, but that work in these products. Many of regulated for other reasons, but we need to explicitly regulate them for business conduct, capital, margin, and reporting for credit default swaps and the products for tailored and standardized products.

I think second we need a regime that brings as much of the product as possible, the standardized product, into centralized clearing to lower risk. There are some voluntary features of that now, but we also need greater transparency through exchanges, while still recognizing there will be tailored and customized products that would be fully regulated in the first regime, but might not get the added risk reduction in the second regime and the added transparency in the second regime.

I think credit default swaps might have some unique features. In addition to what we have laid out in testimony today, I think the regulators, certainly the CFTC and the SEC working together, really have to consider additional features even with regard to credit default swaps, because they perform so many functions like securities.

Senator KLOBUCHAR. You mentioned the systemic risks. What do you think of this idea of having some kind of systemic risk regulator at the Federal Reserve or someplace that looked at the market as a whole?

Mr. GENSLER. Senator, I think that there are many lessons out of this crisis that developed in the last several years, but I think one of the lessons is that we need at the Federal level some clear authorities and mandates from Congress as to when a regulator can step in to protect against systemic risk.

All of the regulators, the CFTC included, primarily were put in place not to protect against systemic risk but to protect against very important risks to the public, but other risks. I think if Congress, working with the administration, moves forward, we should have a party or a mechanism such that the most relevant firms that could lead to crises might have additional standards and addi-

tional risk limitations to be less interconnected to protect the American public.

Senator KLOBUCHAR. As we head into the summer now—a lot of my constituents have cabins; this one is for them—they start to see the oil prices going up again. Why do you think oil is going up, what do you think we can best do to protect ourselves?

Mr. GENSLER. I think at the core of the mission of the Commodity Futures Trading Commission is to make sure that the markets are fair and orderly and that there is integrity. In the energy markets, I do believe that in the past asset run-up that financial institutions participated in that asset bubble. I think as this economy starts to recover—and we all hope for and are working hard for it to recover—that we will see some movement in commodity prices.

But I have said to the staff already—I have been there 8 days—that we have to look at every available option within our current authorities to see how we can protect the public and assure that there are not—as is our mandate, to make sure that there are not burdens from excessive speculation. And though it is not well defined in statute, it is a key mission of ours. I have asked for every option to be on the table, and I appreciate that as the summer moves forward, we might see more movement in these prices.

Senator KLOBUCHAR. Thank you.

Chairman HARKIN. Mr. Gensler, thank you very much for being here today and for your very open and frank discussion of these issues. It is very refreshing to have that kind of openness and just frank responses and answers. I appreciate it very, very much.

As we move ahead in this, we will be taking action this year, as I said at the beginning. We need your input to us on authority, which you just mentioned here; if there is additional authority that you need to carry out your mission, we need to know that, and what additional resources that you need to carry out some new responsibilities that I think that we may be giving you at the CFTC, charging you with. So we need to know that.

I know budgets are tight. I do not want to promise the sun, the moon, and the stars and everything like that. But I think the public is aware of the need for better regulation and whatever small amount of cost that might be I think will be more than outweighed by the public benefits that come through a better regulatory regime.

So we need to keep our lines of communication open on those two things—authority and resources. And I would yield to Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman, and I think all of my questions have been answered. I did want to make just one comment, though.

The Chairman as well as Secretary Geithner have both expressed, as we have talked about, this customized versus standardized transactions, that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing, and we talked about there are some clearinghouses out there now that are voluntarily accepting some of these transactions.

There was an interesting article in the Financial Times yesterday where three of these voluntary exchanges—the New York Ex-

change, the ICE Exchange, and the London Exchange—were warning Congress to be careful about this and careful about mandating and forcing too much of the over-the-counter derivatives into the clearinghouses, particularly because these tailored OTC derivatives being forced into clearinghouses that are ill equipped will really create a problem. And I would simply like to ask that a copy of that article be inserted into the record.

Chairman HARKIN. Without objection.

[The following information can be found on page 138 in the appendix.]

Chairman HARKIN. I could get into that, but we would probably get into a debate, and I do not mean to engender that right now. But I would say that I sat here in 1999 and 2000—I was not Chairman then, but I sat here and listened to all the reasons why we could not regulate. And I have the record. The question I asked of Mr. Greenspan when he sat here—not in this room—about the exposure and the regulation of these and what would happen if we did not do that. I am proud of the fact I am one of nine Members of the Senate who voted against deregulation of Glass-Steagall.

But I asked him that on the record, and I remember his answer. It is on the record. I have got it. He said do not worry—and I am paraphrasing. He said not to worry. He said these are smart people, and they will self-regulate because it is in everybody's interest to make sure that nobody else cheats.

Well, fooled once, your mistake. Fooled twice, my mistake.

Thank you very much, Mr. Gensler, for being here.

Mr. GENSLER. Thank you, Mr. Chairman. Thank you, Ranking Member Chambliss and members of the Committee. I look forward to working with you on this very important agenda for the American public.

Chairman HARKIN. I appreciate that very much, Mr. Gensler, and I want to thank the members of the Committee that showed up. I think this is one of the most important hearings that we are going to have this year. I thank the members of the Committee that showed up. I know everyone is busy around here, but I just cannot think of anything more vitally important that we are going to do this year than to address this issue.

Thank you very much, Mr. Gensler. Congratulations again.

We will call our second panel up; Ms. Lynn Stout, Professor at UCLA School of Law in Los Angeles, California; Mr. Mark Lenczowski—I hope I pronounced that right—Managing Director at JPMorgan Chase & Company; Dr. Richard Bookstaber, from New York; Mr. David Dines, President of Cargill Risk Management, and I will yield to Senator Klobuchar for purposes of introduction there; Mr. Michael Masters—oh, I understand he was traveling and evidently his connecting flight was canceled due to weather problems. He is on his way? OK.

Now Mr. Daniel Driscoll, Executive Vice President and Chief Operating Officer of the National Futures Association in Chicago.

If you will all take your seats, and, again, I would yield to Senator Klobuchar for the purposes of an introduction.

Senator KLOBUCHAR. Well, thank you very much, Mr. Chairman. I am just here to welcome Mr. Dines to the panel. He is from the Cargill Company, which is a very successful company located in

Minnesota, the biggest private company in the country. He was named President of Cargill Risk Management in April 1999. Cargill Risk Management is responsible for providing risk management products to producers, consumers, and investors in the agriculture and energy areas. He joined Cargill's Financial Markets Division in 1992, and in May 1994, he was asked to help start Cargill Risk Management, which is a new business venture for Cargill. And so we look forward to his words today.

Welcome to Washington.

Mr. DINES. Thank you, Senator Klobuchar. It is very nice to be here today. Thank you.

Chairman HARKIN. Well, we thank you all for being here. I know you have heard our interchange with Chairman Gensler. At the outset, I will say that all your statements will be made a part of the record in their entirety. I would like to ask if you could perhaps sum it up in 5 minutes, maybe, so we can have a round of questioning from the Senators.

I will just start in the order in which I introduced everyone, so we will start with Dr. Stout, and then we will move across the panel. Dr. Stout, please proceed. Welcome.

**STATEMENT OF LYNN A. STOUT, PAUL HASTINGS PROFESSOR
OF CORPORATE AND SECURITIES LAW, UNIVERSITY OF
CALIFORNIA-LOS ANGELES, LOS ANGELES, CALIFORNIA**

Ms. STOUT. Thank you, Mr. Chairman, thank you, members, for inviting me to testify today. My name is Lynn Stout. I am the Paul Hastings Professor of Corporate and Securities Law at the University of California at Los Angeles. My scholarly expertise actually includes the theory and the history of derivatives regulation. I also serve as an independent trustee of a large mutual fund that uses derivatives, so I have practical experience with the derivatives markets. And I have actually published several rather lengthy and, at the time to many people, I am sure, boring articles on derivatives regulation.

Please allow me to note that in these articles, which I published in the 1990's, I predicted that deregulating financial derivatives was likely to result in increased market risk, reduced investor returns, and price distortions and bubbles. I am as distressed as anyone that these predictions proved to be correct. However, I made the predictions because if you study the history and the theory of derivatives markets, you will inevitably reach four basic conclusions.

The first conclusion is that, despite industry claims—the industry seems to have a very short memory—derivatives are not new and they are not particularly innovative. There were derivative markets in the United States in the 19th century. Derivatives, of course, frequently go by many different names. The jargon that surrounds them is unnecessarily complicated. In the 19th century, however, they were called “difference contracts,” they were regulated by contract law.

I can cite to you the 1884 Supreme Court case of *Irwin v. Williar*, 110 U.S. 499, which essentially held that off-exchange derivatives were legally unenforceable unless the party entering the derivatives trade could prove they had a bonafide economic risk that they

were hedging against. So this is not a new issue, and the regulation of derivatives is not new.

Second, I can testify from my study of the history of derivatives that healthy economies regulate derivatives markets. This was true in Japan in the 15th century. It was true in the United States all the way up until the passage of the Commodities Futures Modernization Act of the year 2000.

Third, studying the theory of derivatives, it is true that derivatives trading can provide some economic benefits to the economy. Let me make a note. Clearly, derivatives trading can provide benefits to individual derivatives traders, just as gambling can provide benefits to individual gamblers. My focus—and I suspect the Committee's focus—is on the public good. And from the public's perspective, the primary economic benefit that you can get from derivatives trading is from risk hedging.

However, although the industry routinely claims that there are enormous risks hedging benefits, not to mention some offhand liquidity and price discovery benefits from derivatives trading, my research was unable to uncover any significant empirical evidence of the magnitude of these benefits. This is a claim I have been seeing be made by the industry for 20 years now. I thought I would update my research for this hearing.

They still have not generated any empirical evidence, any statistical evidence that demonstrates that the economic scope of these benefits is worth the costs that go along with them. And history teaches us that unregulated derivatives markets carry some very significant economic costs, including a very strong historical association with asset price bubbles, a very strong historical association with increased market risk and the failure of institutions. This goes back 500 years. We do not need to just focus on Orange County, Barings Bank, Long Term Capital, Enron, AIG, and Bear Stearns.

Third, derivatives regulation has historically been justified in part on the theory that encouraging speculation actually reduces economic productivity by diverting valuable resources, especially human creativity, time, and energy, away from more productive industries that contribute more to social welfare.

Fourth, derivatives trading is very clearly associated with increased levels of fraud and manipulation in the underlying markets.

Finally, the last lesson that the history of derivatives regulation can teach us is that successful derivatives trading regulation is possible and has been done. Generally, it has been accomplished quite successfully through a web of complex procedural rules that include reporting requirements, listing requirements, margin requirements, position limits—which I think are very important—insurable interest requirements, and limits on enforceability.

The joy of these rules is that they can be put in place *ex ante* so that derivatives traders know what is and is not required of them and can make plans. It does not call for excessive discretion on the part of an omniscient government regulator, and the rules are very time tested. They have done historically a very good job of permitting legitimate, socially beneficial derivatives trading for

risk hedging purposes while weeding out excessive speculation, excessive risk, and excessive manipulation.

If you will indulge me just briefly, I do think one thing that is really worth saying is people frequently discuss how complicated this issue is, and in the weeds, it is complicated. But the basic problem that we face from a policy perspective is actually quite simple. Although Wall Street surrounds derivatives with jargon, they are essentially one thing; they are a bet or a gamble on something that is going to happen in the future. And when I bet on a horse to win a race, my race ticket is my derivative contract. When I bet on the creditworthiness of a corporate borrower, my credit default swap is my derivative contract.

Betting can obviously be used to hedge against risk, so if I actually own a corporate bond and then I purchase a credit default swap, I have reduced my risk because if my bond goes down in value, my credit default swap goes up. But it is very important to recognize that derivatives can also be used and are especially attractive purely for speculative purposes. There actually is a clear economic definition of "speculation." It is trying to make money not by producing something or by providing investment funds to someone who is producing something, but instead by trying to predict the future better than someone else can.

As a practical matter, it can be difficult to establish that a particular derivatives trade is speculative in nature simply because traders are really good at making up alleged risks that they are supposedly hedging against. However, for 200 years, regulators have succeeded in coming up with ways to weed out true risk hedging from speculation, and this can be done, for example, at the macro level. I simply want to cite to you we may not know with exactitude which credit default swaps were exact hedges and which ones were speculation.

We can be quite certain by 2008 the CDS market was overwhelmed by speculation. We know this because the notional value of credit default swaps in 2008 was approximately \$67 trillion; whereas, the notional value of the bonds, both mortgage-backed bonds and corporate issue bonds that the credit default swaps were being written on, was less than one-fourth that size. It was \$15 trillion. When the derivatives markets is 4-1/2 times the size of the market for the underlying thing you are supposedly hedging the risk of, you know the market has been swamped by speculation with, I would say, sadly predictable results that we are now trying to sort through today.

So I think that is probably a good enough start.

[The prepared statement of Ms. Stout can be found on page 131 in the appendix.]

Chairman HARKIN. That is a great start. OK. Thank you, Dr. Stout.

We now turn to Mr. Lenczowski, Managing Director of JPMorgan Chase. Mr. Lenczowski.

**STATEMENT OF MARK LENCZOWSKI, MANAGING DIRECTOR,
JPMORGAN CHASE & CO., WASHINGTON, DC**

Mr. LENCZOWSKI. Thank you, Chairman Harkin, Ranking Member Chambliss, and members of the Committee. My name is Mark

Lenczowski, and I am a Managing Director and Assistant General Counsel at JPMorgan Chase & Co. Thank you for inviting me to testify at today's hearing.

For the past 30 years, American companies have used OTC derivatives to manage interest rate, currency, and commodity risk. Increasingly, many companies incur risk outside their core operations that, left unmanaged, would negatively affect their financial performance and possibly even their viability. In response to marketplace demand, financial products, such as futures contracts and OTC derivatives, were developed to enable companies to manage risk.

OTC derivatives have become a vital part of our economy. According to the most recent data, 92 percent of the largest American companies and over 50 percent of mid-sized companies use OTC products to hedge risk.

JPMorgan's role in the OTC derivatives market is to act as a financial intermediary. In much the same way financial institutions act as a go-between with investors seeking returns and borrowers seeking capital, we work with companies looking to manage their risks and with entities looking to take on those risks. Recently, clients, such as Chesapeake and Medtronic, have expressed great concern about the unintended consequences of recent policy proposals, particularly at a time when our economy remains fragile. In our view, the effect of forcing such companies to face an exchange or a clearinghouse would limit their ability to manage the risks they incur in operating their businesses and have negative financial consequences for them via increased collateral posting. These unintended consequences have the potential to harm an economic recovery.

Let me first discuss some of the benefits of OTC derivatives. Companies today demand customized solutions for risk management, and the OTC market provides them. Customization does not necessarily mean complexity. Rather, it means the ability to tailor every aspect of the transaction to the company's needs to ensure that the company is able to match its risks exactly.

For example, a typical OTC derivative transaction might involve a company that is borrowing in the loan market at a floating interest rate. To protect itself against the risk that interests rate will rise, the company will enter into an interest rate swap. These transactions generally enable the company to pay an amount tied to a fixed interest rate, and the financial institution will pay an amount tied to the floating rate of the loan. If rates rise steeply, they have some protection and can focus on their core operations.

OTC derivatives are used in a similar manner by a wide variety of companies seeking to manage volatile commodity prices and foreign exchange fluctuations.

In addition to customization, the other main benefit of OTC derivatives is flexibility with respect to the collateral that supports a derivative transaction. In the interest rate swap example, the financial institution may ask the company to provide credit support to mitigate the credit risk that it faces in entering into this transaction. Most often, that credit support comes in the same form as the collateral provided for the loan agreement. Thus, if the loan agreement is secured by property or equipment, that same collat-

eral would also be used to secure the interest rate swap. This collateral is high quality. It is the basis for the extension of credit in the loan agreement. As a result, the company does not have to incur additional costs in obtaining and administering credit support for the interest rate swap. This is a very significant benefit and without it, many companies will choose not to hedge their risks because they cannot afford to.

It is important to note that although derivatives currently are offered on U.S. exchanges, few companies use these exchange-traded contracts for two main reasons. Exchange-traded products are, by necessity, highly standardized and not customized. As a result, companies are unable to match the products that are offered on exchanges to their unique risks. Second, clearinghouse collateral requirements are onerous, and necessarily so. Clearinghouses require that participants pledge only liquid collateral such as cash or short-term Government securities to support their positions. However, companies need their most liquid assets for their working capital and investment purposes.

While we believe that exchanges play a valuable role in risk management, not all companies can or want to trade on an exchange. Currently, companies have the choice of entering into their hedging transactions on an exchange or in the OTC market. For most companies, OTC derivatives are critical to their risk management, and risk management is critical to their operations in volatile times. We believe that companies should continue to be allowed to have the choice to use these products.

This discussion of the benefits of OTC derivatives is not to deny that there have been problems with their use, and it is essential that policymakers examine the causes of the financial crisis to ensure it is never repeated. We have noticed reports in the press that derivatives dealers are working to avoid regulation. This is absolutely wrong. The efforts that have been reported on are part of a 4-year effort with regulators to enhance practice in the OTC derivatives market. The latest letter is just the last quarterly submission outlining our efforts to enhance market practice.

To that end, we propose the following, which is consistent with the administration's position and Chairman Gensler's testimony today.

First, financial regulation should be considered on the basis of function not form.

Second, a systemic risk regulator should oversee all systemically significant financial institutions and their activities.

Third, all standardized OTC derivatives transactions between major market participants should be cleared through a regulated clearinghouse.

Lastly, enhanced reporting requirements should apply to all OTC derivatives transactions.

JPMorgan is committed to working with Congress, regulators, and other industry participants to ensure that an appropriate regulatory framework for derivatives is implemented. I appreciate the opportunity to testify, and I look forward to your questions. Thank you.

[The prepared statement of Mr. Lenczowski can be found on page 95 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Lenczowski.
Now we turn to Dr. Richard Bookstaber. Dr. Bookstaber.

STATEMENT OF RICHARD BOOKSTABER, NEW YORK, NEW YORK

Mr. BOOKSTABER. Mr. Chairman and members of the Committee, I thank you for the opportunity to testify today. My name is Richard Bookstaber. During my career I have worked extensively in risk management, and I was also one of the pioneers in the development of derivative products on Wall Street. I am the author of the book "A Demon of Our Own Design; Markets, Hedge Funds, and the Perils of Financial Innovation." That book, published in April of 2007, warned of the potential for financial crisis from derivatives and other innovative products. Although I have had extensive experience in both investment banks and hedge funds, I come before the Committee in an unaffiliated capacity and represent no industry interests.

My testimony will focus on reducing complexity and increasing transparency in the derivatives markets through standardization and exchange trading. Derivative instruments—and I use the term to include options, swaps, and structured products—can improve financial markets. They can allow investors to mold returns to meet their investment objectives, to more precisely meet the contingencies of the markets. They can isolate and package risks to facilitate risk sharing.

However, derivatives also can be used for far less lofty purposes, like allowing firms to lever when they are not supposed to lever; take exposure in markets where they are not supposed to take exposure; and avoid taxes that they are supposed to pay. In short, derivatives are the weapon of choice for gaming the system. These objectives are best accomplished by designing derivatives that are complex and, thus, opaque so that the gaming will not be readily apparent.

Such complexity, as I point out in my book, makes the financial markets crisis prone. Complexity hides risks and creates unexpected linkages between markets. Because derivatives are the primary source of this complexity, to reduce the risk of crisis we must address the derivatives markets. We need a flight to simplicity.

The proposed centralized clearing corporation, while a welcome step, is not sufficient to do this. It may address counterparty concerns, but it will not sufficiently address issues related to standardization, transparency, price discovery, and liquidity. To do that, we need to have standardized derivative products and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in transparency and efficiency, and it will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivatives-induced complexity creates.

Now, one stated objection to standardization and exchange trading is that having some products out in the light of day will only increase the demand for the more shadowy and opaque products. Another objection is that the push toward standardization will reduce innovation. These concerns lead to demands by some to abol-

ish all OTC derivatives and by others to shrink from exchange trading. There is no need to move toward either of these two extremes. We can have a combination of standardized exchange-traded instruments along with the continued development of customized OTC instruments.

Abolishing OTC derivatives is not wise. There will be legitimate reasons for customized derivatives and no doubt innovations will emerge with broad value to the financial markets. The point is not to stifle innovation but to assure it is directed toward an economic rather than a gaming end.

Standardized exchange-traded derivatives will create a hurdle for any nonstandard over-the-counter product. The over-the-counter product will have worse counterparty characteristics, be less liquid, have a higher spread, and have inferior price discovery. To overcome these disadvantages, the nonstandard OTC product will have to demonstrate substantial improvements in meeting investment needs compared to the standardized product. Also, and importantly, stricter controls can be placed on nonstandard OTC derivatives. For example, the regulator may mandate the disclosure of OTC positions and require a demonstration of why they are being used instead of a standard product.

While there will still be the opportunity for innovation and for the application of the more complex derivatives, I believe that for most legitimate purposes the standardized products will be found to be adequate.

Now, financial institutions might have to be pulled less than willingly into any initiative to standardize derivatives or to move derivatives from over-the-counter onto an exchange. They have an incentive to keep derivatives over-the-counter and not standardized. For the bank, the more complex the instrument, the greater the chance the bank can price in a profit for the simple reason that investors will not be able to readily determine the fair value. And if the bank creates a customized product, then it can charge a higher spread when an investor comes back to trade out of the product.

For the trader, the more complex the instrument, the more leeway he has because it will be harder for the bank to measure his risk and price his book. And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic gaming objectives they might have in mind.

In conclusion, we should move toward standardization and exchange trading of derivatives. And we should do this because it is the reasonable direction to go, not as a reaction to the current crisis and not predicated on whether derivatives were the villains of this crisis or merely innocent bystanders.

The argument for standardization and exchange trading of derivatives is compelling. But there remains much we do not know. Therefore, it is important to move slowly, learning by doing rather than pushing for quick, wholesale solutions.

There are markets that are beyond the purview of the CFTC, indeed that are beyond our borders, so the natural pace will be a gradual one.

Thank you for the opportunity to provide this testimony, and I look forward to your questions.

[The prepared statement of Mr. Bookstaber can be found on page 64 in the appendix.]

Chairman HARKIN. Thank you very much, Dr. Bookstaber.

Now we turn to Mr. David Dines, President of Cargill Risk Management. Mr. Dines, welcome.

**STATEMENT OF DAVID DINES, PRESIDENT, CARGILL RISK
MANAGEMENT, HOPKINS, MINNESOTA**

Mr. DINES. Thank you, Mr. Chairman. My name is David Dines, President of Cargill Risk Management. I am testifying on behalf of Cargill, Incorporated, and I want to thank you for the opportunity to be here today.

Cargill is an extensive end user of derivatives and relies heavily upon efficient, competitive, and well-functioning futures and over-the-counter markets. One of the major challenges for policymakers and regulators is that the term "over-the-counter" covers a vast array of products across a number of markets. This broad definition highlights why it is extremely difficult to seek a one-size-fits-all regulatory or legislative solution that still allows all interested parties to manage or hedge their genuine economic risks.

One major concern with the recent proposal by the Treasury Department is that it appears to seek a regulatory solution for all OTC products in response to systemic risk posed by one particular market; credit default swaps.

It is important to note that while we have witnessed the greatest economic crisis in 80 years, OTC contracts in the agriculture, energy, and foreign exchange markets performed well, did not create systemic risks, and, in fact, helped many end users manage and hedge their risks during this very difficult time.

In today's hearing, we will focus our comments on three of the four objectives of the recent Treasury proposal. We support the stated objectives and believe that steps could be taken to meet these goals, without denying end users' access to an effective and competitive market.

The Treasury Department's first objective is to prevent activities in the OTC markets from posing risk to the financial system. The outline seeks to apply mandatory clearing of all standardized products and impose robust margin requirements to meet this objective.

The imposition of mandatory clearing and mandatory margining of tailored hedges will have a significant drain on working capital. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital requirements.

The potential magnitude of this drain on working capital should be carefully weighed by all policymakers. I would like to submit for the record a letter from the National Association of Manufacturers as well as a recent letter from Chesapeake Energy, an Oklahoma-based end user of OTC derivatives and the largest independent producer of natural gas. The Chesapeake Energy letter provides an excellent example of how imposing mandatory margining could severely drain capital that could otherwise be invested to grow a business.

[The following information can be found on page 139 in the appendix.]

Mr. DINES. In the one example provided here, over \$6 billion would have been taken away from running and expanding a job-creating business, and instead be left idle in a margin account until the maturation of the OTC contract—a contract which had already been secured with collateral. Expand this example across all businesses that use OTC products and the amount of capital diverted from growing the U.S. economy would be severe, unless companies reduced their hedging and risk management.

There is a misconception that OTC products do not have credit provisions and are never collateralized or margined. A significant number of OTC transactions are collateralized, margined, or make use of credit agreements to secure the contract with collateral being moved daily to adjust for the change in market value.

With regard to mandatory clearing of standardized products, defining which products are “standard” and which products are “customized” is a complex issue that must be thoroughly examined by the appropriate Federal regulator to avoid disrupting market segments that continue to perform well.

The loss of tailored hedging tools will also greatly impact the ability of companies to comply with current accounting standards. The Treasury Department outline also indicates that substantial capital requirements could be placed on all OTC dealers.

There is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers. The agriculture and energy hedging sectors have active non-financial institution OTC dealers who offer healthy competition in the market, and it would be inappropriate to eliminate these competitors from the OTC market through legislative or regulatory action.

To meet the Treasury Department’s first objective of protecting the financial system, regulatory requirements should be risk based and not one size fits all. Additional monitoring and transparency is warranted; however, restricting working capital through major increases in mandatory margining in these markets is counter-productive.

Objective 2: The Treasury Department’s outline seeks to impose more recordkeeping and force trades onto regulated exchanges to promote efficiency and transparency within the OTC markets. We recommend more recordkeeping and better disclosure, although the regulator should be directed to focus on areas with the greatest risks. As previously mentioned, mandatory movement of activities from the OTC market to an exchange-traded market does not seem warranted in those markets that have not created systemic risks to the financial system.

Objective 3: The Treasury Department’s outline seeks clear authority to police fraud and market manipulation and the authority to set position limits on OTC derivatives. Cargill recently filed comments with the CFTC on a proposed rulemaking that addresses this objective where we support position limits for non-commercials, much greater transparency and reporting for over-the-counter markets, and we offered detailed suggestions for implementation.

In summary, Cargill recommends that additional legislative and regulatory actions in the OTC market are risk based and not treat all products identically; seek to add minimal costs and disruptions

to those products that have not posed systemic risk to the financial system.

Two, mandatory clearing and margining would severely reduce hedging activity, would greatly restrict working capital at a time when it is in very short supply, and is not warranted for OTC products that have not created systemic risk.

Third, the CFTC, through its existing rulemaking, is proposing much needed steps and should continue to work on ensuring the enforcement of position limits in related exchange-traded markets, principally agriculture and energy products, and improving transparency and reporting of OTC products.

We appreciate the opportunity to testify today and look forward to working with the members of the Senate Agriculture Committee and other policymakers as this issue develops. Thank you.

[The prepared statement of Mr. Dines can be found on page 71 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Dines.

Now we will turn to Mr. Michael Masters. You did show up.

Mr. MASTERS. Coming from the West Coast.

Chairman HARKIN. I understand you took an overnight flight.

Mr. MASTERS. Yes, I had a little trouble getting here with the thunderstorms last night.

Chairman HARKIN. Welcome, Mr. Masters, of Masters Capital Management, and as I said earlier, your statements will be made a part of the record in their entirety, and please, if you would take 5 to 7 minutes or something like that, I would appreciate it very much.

Mr. MASTERS. Sure.

Chairman HARKIN. Thank you, Mr. Masters.

**STATEMENT OF MICHAEL W. MASTERS, MANAGING MEMBER/
PORTFOLIO MANAGER, MASTERS CAPITAL MANAGEMENT,
LLC, ST. CROIX, U.S. VIRGIN ISLANDS**

Mr. MASTERS. Thank you. Good morning, Chairman Harkin and members of this Committee. The derivatives markets present Congress with two very critical and very distinct problems; systemic risk and excessive speculation.

Last fall, the world financial system teetered on the brink of collapse. This near-meltdown had a catastrophic effect on our Nation's economy, causing the loss of trillions of dollars in retirement savings and millions of American jobs. At the peak in 2008, the notional amount of over-the-counter derivatives outstanding totaled over two-thirds of a quadrillion dollars. These positions formed an interlocking spider web of enormous exposures amongst the 20 to 30 largest swaps dealers and represented an extreme amount of leverage since very little margin collateral backed up these huge bets.

This unregulated shadow banking system was effectively destroyed in the fall of 2008. It threatened to destroy the regulated financial system with it. However, regulators pumped trillions of dollars into the shadow banking system to allow OTC derivatives dealers to make each other whole on their bets. This was necessary to prevent a domino effect of dealer collapses that would have destroyed the world's financial system.

Congress owes it to the American people to ensure that this never happens again. The risk of a financial system collapse must be eliminated, not regulated. Everyone agrees that clearing needs to take place in order to increase the transparency of these markets. But not all clearing is created equal. This clearing process must include two important provisions.

First, clearing must involve novation wherein the derivatives clearing organization becomes the central counterparty to both sides of the trade. This will eliminate the interlocking spider web of exposures among swaps dealers because every dealer's exposure will be to the central counterparty and not to each other.

Secondly, clearing must involve daily margin where every day the central counterparty collects margin payments from those dealers whose bets are going against them. This ensures we never have another AIG.

If this system had been in place in 2008, then it would have been virtually impossible for the financial system to melt down.

Wall Street will seek to block mandatory exchange clearing by arguing that swaps are highly customized and cannot clear. This is false. The standard that regulators should adopt is not one of standardization versus customization, but one of clearable versus non-clearable. Chairman Gensler said during his confirmation hearing that if an OTC derivative can clear, then it should clear. Treasury Secretary Geithner said if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and, thus, required to be cleared. This is the right standard and will result in a vast majority of swaps clearing through an exchange. Exchange clearing will lead to price transparency, tighter bid-ask spreads, and greatly reduced cost for end users of the swap markets. There will also be greater liquidity due to lower trading cost and reduced emphasis on credit concerns.

Now let us look at excessive speculation. America experienced a bubble in food and energy prices during 2008. This was caused by excessive speculation in the derivatives market for these commodities. These markets have become dominated by speculators, and prices no longer reflect supply and demand.

Now, in 2009, the problem is once again raising its ugly head. Today, the supply of crude oil in the U.S. is near a 20-year high, while the demand is near a 10-year low, according to the IEA. Yet the price of oil has risen an amazing 85 percent this year, from the mid-30's to the mid-60's. There has been a chorus of voices from oil market participants, economists, and even OPEC squarely pinning the blame on speculators for unjustifiably driving oil prices higher. If Congress allows this to continue, then high oil prices threaten to throw our economy back into the double-dip recession and potentially ruin the Obama stimulus.

Your constituents are flat on their backs financially and will not tolerate gasoline prices rising to \$3 or \$4 again. The excessive speculation problem can be eliminated by imposing aggregate speculative position limits. These limits must cover all trading venues which will require closing all the existing loopholes to ensure that every venue is regulated equally.

The swaps loophole is an exemption granted by the CFTC which gives swaps dealers free rein to buy and sell commodity futures in unlimited quantities. The best way to close it is to mandate that all OTC commodity derivatives clear through an exchange. This needs to happen to eliminate systemic risk, but it also needs to happen so that regulators can actually apply position limits. When a swap clears, the exchange breaks that transaction into component parts and becomes the center counterparty to both sides of the trade. This enables regulators to see both sides and enforce aggregate speculative position limits.

The London loophole occurs when foreign hoards of trade are permitted to trade contracts that are virtually identical to U.S. futures contracts. The solution is simple, foreign exchanges must be required to supply all the same data that designated contract markets provide to the CFTC, and they must enforce speculative position limits.

Right now, the possibility for cross-border regulatory coordination is at an all-time high. G-8 Ministers issued a statement last week along with OPEC calling for greater regulation to crack down on excessive speculation in the energy markets.

The CFTC must set the limits for all consumable commodities, not the exchanges. Speculative position limits should be set for the commodity as a whole rather than one particular grade or delivery or location, for instance, crude oil, not just West Texas Intermediate. Speculative position limits need to be aggregated across trading venues.

In summary, the best way to eliminate the risk of another financial system collapse is to mandate that all OTC derivatives clear through an exchange with a novation and daily margin. And the best way to prevent another bubble of excessive speculation is to make aggregate speculative position limits apply across all trading venues.

The CFTC has 70-plus years of experience regulating exchange clearing and policing markets for excessive speculation. The SEC and Federal Reserve have little to no experience in these two key areas. In fact, the SEC has allowed passive commodity investments in ETFs, ETNs, and commodity mutual funds.

They have signed off on double-leveraged crude oil EFTs like the DXO that allow any investor to make leveraged speculative bets in crude oil within their retirement accounts. This does not show good judgment from a consumer protection or a market protection standpoint. For these reasons, the CFTC is the best and most appropriate regulator for the job.

Thank you. I look forward to your questions.

[The prepared statement of Mr. Masters can be found on page 101 in the appendix.]

Chairman HARKIN. Well, thank you very much, Mr. Masters, for summarizing a very extensive statement you had here, which I read last night, which I found extremely interesting.

Now we turn to our final person here. This is Mr. Daniel Driscoll, Executive Vice President and Chief Operating Officer of the National Futures Association. Mr. Driscoll, welcome.

STATEMENT OF DANIEL A. DRISCOLL, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. DRISCOLL. Thank you very much, Chairman Harkin, Ranking Member Chambliss, and all the members of the Committee for allowing us to participate here and to ask you to close a loophole where fraudsters are able to offer over-the-counter derivative contracts to the retail public.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry, and we also regulate over-the-counter retail forex products. NFA is first and foremost a customer protection organization, and we take that mandate very seriously.

Now, the other witnesses today have talked primarily about OTC derivative products that are offered to and traded by large, sophisticated institutions. But I am here to tell you that there is also a growing aspect of the OTC derivatives markets that is directed toward the retail public, and those customers are being victimized in a totally unregulated environment.

Now, for many years, retail participants in the futures markets have enjoyed all of the benefits of the Commodity Exchange Act. Their contracts were traded on regulated exchanges and cleared by regulated clearing organizations. Their brokers had to meet the fitness standards of the Act and were regulated by the CFTC and NFA. However, today, there are too many customers that do not receive any of the benefits of regulation, and we need to do something about that.

The main problem stems from a court case often referred to as the Zelener case, which was a Seventh Circuit Court of Appeals Case involving a CFTC enforcement case alleging forex fraud. In that case, the district court ruled that the customers were, in fact, defrauded but that the CFTC did not have jurisdiction because the contracts were not futures contracts.

In that particular case, the contracts were offered to the retail public for speculative purposes. They were rolled over and over again so that delivery never took place. Basically they were the functional equivalent of a futures contract.

Unfortunately, the Seventh Circuit ignored those characteristics and ruled that the written contract itself should determine the nature of the contract, and because the contract did not guarantee a right of offset, they ruled that they were not futures contracts, and the CFTC lost that particular case. There were other courts that followed the Zelener decision and came up with similar rulings over the next several years.

Last year, Congress closed the forex loophole but, unfortunately, the loophole is not limited to forex so that customers dealing in other OTC products, such as gold and silver, are still in a regulatory mine field, and we need to bring regulatory protections to those customers as well.

Back in 2007, NFA predicted that if Congress plugged the Zelener loophole for forex but left it open for other products, the fraudsters would simply move over to Zelener-type contracts in other commodities, and that is exactly what has happened. Now, we cannot quantify the exact numbers of that fraud because these firms are not regulated and are not registered. But we are aware

of dozens of firms that offer Zelener contracts in metals and energy.

Recently, we received a call from a man who lost over \$600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints and mounting customer losses involving these products since Congress closed the loophole for forex.

NFA and the exchanges have previously proposed a fix which would close the Zelener loophole for these non-forex products. Our proposal codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*, which was the accepted state of the law until Zelener. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts unless delivery is made within 7 days or the retail customer has a commercial use for the commodity. This presumption is flexible and could be overcome by showing that delivery actually occurred or that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements.

This statutory presumption would not cover securities and banking products, it would not interfere with inter-bank currency markets, and it would not cover the retail forex contracts that are already covered or exempt under Section 2(c). I would also say that our proposal would not invalidate a 1985 interpretive letter issued by the CFTC, which Monex and other similar firms currently rely on to sell gold and silver to their clients. Essentially, that letter set forth a factual pattern which culminated in the actual delivery of the precious metals within 7 days and title to those metals going over to the retail customer so that it would not be covered under our statutory proposal.

In conclusion, while we support Congress' efforts to deal with systemic risk and create greater transparency in the OTC markets, Congress should not forget that there is a very real risk to the retail public participating in another segment of these markets. The Committee can play a leading role in protecting customers from the unregulated boiler rooms that are currently taking advantage of the Zelener loophole for metals and energy products. We look forward to further reviewing our proposal with Committee members and staff and working with you on this important matter.

Thank you.

[The prepared statement of Mr. Driscoll can be found on page 77 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Driscoll. Thank you all for your testimony. I cannot help, Mr. Driscoll, but to comment upon your statement. I offered an amendment on the last farm bill to close Zelener. We passed it in the Senate.

Mr. DRISCOLL. Yes, thank you very much.

Chairman HARKIN. Well, we did it, and we went to conference and lost it in conference. All we were able to keep out of that was just the forex contracts that you are talking about. Again, I think that was a mistake, and I said so at the time. But it did not have the votes. So I am glad to hear your testimony again today calling for a broader closure of the Zelener loophole that the Seventh Circuit opened up for everybody. It went beyond currency, and they

applied it to everything else. So I appreciate your comments today, and hopefully maybe if we move some legislation this year, we can also finally close that loophole.

Mr. DRISCOLL. Thank you, Senator Harkin.

Chairman HARKIN. I just could not help but comment on that.

It seems like everyone here is basically saying that there is a legitimate need for derivatives trading, I think, if I am not mistaken, but that it would be well regulated, transparent, but there is some need for some liquidity in the marketplace that might be provided by that. I am reminded of what one person said to me, a Congressman said to me, a former Congressman said to me one time about liquidity. He said, "You know, liquidity is good, but too much liquidity can be bad." He said, "It is like I take an aspirin every day. My doctor says I should take an aspirin every day for liquidity. But if I took a whole bottle every day, it might be kind of dangerous to my health." So I have often thought about that kind of analogy.

I also think about the analogy that Dr. Bill Black testified to last fall when we had our first hearing on this. Someone had commented upon, well, we do not want to stifle the free flow of capital, to which Dr. Black responded, "Well, I do not know," he said, "if we really want the free flow of capital; maybe we want the more efficient flow of capital." And he used the analogy of traffic flow.

He said, "You know, if we want the free flow of traffic, do away with all the stop lights. Do away with the stop signs. Do away with the speed limit signs. You will have a very free flow of traffic. But you are going to have a lot of wrecks." And he analogized that to the financial markets, that we need regulation, we need the stop lights and the slow-down signs and the danger signs and things like that, not so much for the free flow of capital, but for the more efficient flow of capital.

Now, with that as a backdrop, I understand the need for liquidity. I also appreciate, Dr. Stout, your testimony. A lot of this gets clouded in jargon. We say, oh, this is complex and all that. But it kind of boils down to certain essentials all the time. And I will start here with what Mr. Lenczowski testified to, and that is that many banks relied on credit default swaps instead of fully meeting capital requirements.

So we have heard a lot of discussion here about, well, we should not have to come up with capital requirements too much. I think maybe Mr. Dines maybe testified to that; I think maybe somebody else did, that requiring too much capital requirements might stifle the transactions and the more open flow of capital and hedging. But many banks relied on these credit default swaps instead of meeting the capital requirements under the Basel II rules—I had to learn this, too, what Basel II was—thus contributing to the buildup of excessive leverage and risk.

So I guess a question for all of you basically is this; how do we control the risk to the financial system and our broader economy when institutions rely on derivatives too much and we do not have as much capital coming forward? So that is really what we are trying to wrestle with here.

Now, again, I will make another statement as sort of a backdrop to what I am getting at here. There have been a couple of articles in the Wall Street Journal and New York Times recently, and they

concluded that the banks and other over-the-counter swaps dealers oppose certain reforms for the basic reason that the greater transparency and disclosure involved in exchange trading would impair their ability to make profits. That is, if the parties on the other side of transactions had a better idea of what prevailing prices are for swaps, then the banks and swap dealers would not be able to charge as much as they can if they kept them off the exchange, in the dark and out of sight.

I want to state emphatically I am not opposed to the financial sector making profits. They have done very well in the last few years, I might note, but I think there is also a countervailing tremendous public interest at stake here. When we have to come up with \$4 trillion to rescue the economy, a bill that we will be paying and our kids and our grandkids will be paying for some time, then I think it argues that we have to balance this desire for making profits, which is fine, with the countervailing balance of the public interest here.

So I do not see this as a really complex issue. What it basically is, on the one hand we have the public interest in protecting the economy from these risks; on the other hand, the quest of the financial sector to make maximum profits. And to me that is just how I see it. It is not much more complex than that. And as I delved more into derivatives and credit default swaps, I then found out that all these things, whether they are credit default swaps, collateralized debt obligations, collateralized mortgage obligations, all these things, hardly any of those existed before 1990. Most of them came up in the 1990's.

I keep asking the question; where was the demand? Where was the demand for these products? I found out there really was not any, just that these quants that I referred to earlier came up with ingenious ways of slicing and dicing all these little derivatives, these tranches, and no one really knew what the value of them was.

I have often said jokingly that I never knew when I was growing up that someday I would need Honey Nut Cheerios. I thought Cheerios was just fine. But all of a sudden, I found out I need Honey Nut Cheerios. Well, that is OK. I do not mind that. That is an innovation. They were able to sell that, no one is hurt, that is fine. But if innovation in this financial sector does not pertain to some underlying value or benefit to the goods and services of the GDP, then it just seems to me to beg for more regulation and oversight.

I did not mean to go on so long on that, but if I had a basic question for all of you, and I will just go down the line; how do we balance this off? How do we provide for liquidity, the aspirin a day but not a bottle a day? How do we provide for innovation that might pertain to underlying value, but not innovation that just allows someone to gamble and make a lot of money, and keep our markets regulated in the public interest, how do we balance those off?

Dr. Stout.

Ms. STOUT. I think that history gives us some very good guidelines because we actually did that pretty well between 1933 and 1934 and the mid-1990's. And I think the legislation that you are pro-

posing, which in many ways reinstates some of those old-fashioned, time-tested, highly successful strategies, is a very good start.

I want to just point out, it is interesting, Simon Johnson of the MIT Sloan School has estimated that between 1973 and 1985, the finance sector of the U.S. economy accounted for 16 percent of corporate profits, and that in the last decade that has increased to 41 percent of all corporate profits were earned by the finance industry.

Although I do not have the exact breakdown, I suspect that many of those profits were actually trading profits earned by hedge funds and by the proprietary divisions of investment banks. Where did they come from? I will simply point out that hedge funds were earning between 10 and 20 percent annual returns over the last decade. Average investors, who are my investors—I am a trustee of a mutual fund; that is the Moms and the Pops who buy our mutual fund interests—they got 3 to 4 percent a year. I do not think that you can assume that is a coincidence.

Chairman HARKIN. Mr. Lenczowski, how do we balance these?

Mr. LENCZOWSKI. Well, first, thank you, again, Chairman, for allowing me to testify. I think first I would to state that at JPMorgan we broadly support the initiatives of the administration and of Chairman Gensler to undertake regulatory reform.

Chairman HARKIN. By the way, I would be remiss if I did not compliment JPMorgan because you are the ones back in the 1990's that did not get involved in that credit default swap mess. And I think you were very prescient on that, so I would be remiss if I did not compliment you on that.

Mr. LENCZOWSKI. On behalf of our institution, thank you.

But to go back to the points you were making, Chairman Harkin, the first thing on capital, and I think just to state as a bank we are subject to very stringent capital requirements already, and I think, if I might, the capital that Mr. Dines was referring to and perhaps Senator Chambliss referred to earlier, we are talking about capital that is coming out of non-banks, out of the end users, the companies in our country that create jobs. And if they were to trade on exchange—which they currently have the right to do, but if they were to be forced to trade on an exchange, they would have to take capital out of their corporations and pledge it to the exchange. That is the way the exchange operates.

So when we talk about a drain on capital, it is not our capital. It is the capital of companies like Cargill, Chesapeake, and they told you how much that would be. It is billions of dollars.

The other point I would make, Chairman Harkin, on demand, the history of the over-the-counter business has been one that has grown in response to customer demand from the relaxation or the dropping of the gold standard in the 1970's and responses to oil price shocks and inflation led to unprecedented volatility in currency rates, in interest rates. This is what led to the interest rate and currency markets to grow, to serve customer needs. These are markets that exist to serve customers, and we serve as a financial intermediary.

You mentioned CDOs. In the early part of this decade, we had a time of very, very low interest rates, of investors looking for enhanced yield and willing to take on extra risk. And the CDO market, the CMO market, and many other structured markets arose in

response to the investor demand for higher yield with higher risk. We have seen what has happened as a result of the collapse in real estate prices.

Last, I would just close, this part at least, by saying that, again, we support clearing. It is an important tool that we currently use. We derive great benefits from it, from credit risk reduction and an operational standpoint, but we think it would be a mistake to impose that kind of a one-size-fits-all requirement on our economy.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. I would disagree to some extent with the last statement. I believe that there is a component of the development of "innovative products" that is very much along the lines of what you, Mr. Chairman, depicted, where the banks or investment banks realize that if they can differentiate themselves, that if they are selling something that other people are not selling, and if it is sufficiently complex, they can price it in a way that people will have difficulty understanding if it is fairly priced or not, and they will be able to trade it with a higher spread because the client does not have many other avenues for trading. So liquidity basically is a negative aspect and complexity is a positive aspect when it comes to profit for the bank or the investment bank.

On the other side, as I think you also pointed out, part of the investor demand that has come for some innovative products has occurred along the "Hey, I got a problem" sort of approach; that is, somebody is trying to say, "You know, I want to lever but I am not allowed to lever. Can you help me out here?" And on that basis, you get new innovations that are helping for these gaming purposes.

I believe that there is a need for innovation, that we can have innovation, but regulators need to, No. 1, find a means to have innovation that is directed toward economic purposes as opposed to gaming purposes. And I do not know the proper method for doing that. I think that it is clear that we need to have capital, margin, haircuts, whatever sort of method is used, to back derivatives and other exposures rather than having them be off balance sheet without sufficient capital background.

I agree also with one point that Mr. Dines said, that it is reasonable to have a distinction between different types of products, though not on the basis of what caused a problem in the past versus what did not, because we do not want to drive through the rearview mirror. But there are some products in some markets that inherently are more systemic by nature. Interest rates and currencies are just by nature going to be more systemic than corn, wheat, and commodities of that type. So we more urgently need to have the ability in those markets to control and to aggregate so that we can detect patterns of crowding that may move us from having an issue where it becomes systemic because many firms are all on the same side of the boat.

Chairman HARKIN. Thank you very much, Dr. Bookstaber.

Mr. Dines.

Mr. DINES. Thank you. I guess I would start by just confirming what was said by the other panelists, and what I said in my testimony is that we, again, do not believe that you can take a one-size-fits-all approach to solving this. The regulatory changes that apply

to credit default swaps may not be and I do not think are appropriate for the energy and agricultural markets. We believe that there should be greater transparency and reporting to the regulators, and we have said that we think that there should be position limits for non-commercials.

We believe that this will go a long ways toward solving the issues. We do not think that mandatory margining and clearing is necessary, and we think that will have unintended consequences of reducing people's hedging, companies' hedging, and that will cause significant risks.

Chairman HARKIN. Unless I misinterpreted what you said, Mr. Dines, you are basically proposing that we separate financials out from commodities.

Mr. DINES. I am saying that we need to take a different approach to these different segments, and what might be appropriate for credit default swaps may not be appropriate for the energy and agriculture markets. I think some do have more systemic type risks than others.

Chairman HARKIN. Yes, I understand.

Mr. DINES. OK. Thank you.

Chairman HARKIN. Mr. Masters.

Mr. MASTERS. Thank you, Senator. I think there are two parts to the question. One is liquidity and one is innovation.

First of all, let us just get out the word "innovation." Innovation is a word that Wall Street uses to talk about anything they do in the financial markets. Innovation by itself has sort of a positive connotation when people think about innovation. But innovation is not always good. You know, Ford had the Edsel. There have been many, many products developed in our economy over the last few hundred years that were not good products. Why is it that everything that Wall Street creates is a good product? There are a lot of bad products. So I would just like to get that out to begin with.

In fact, I would argue that since many of these innovative products affect consumers in a very direct and a very real way, including loss of jobs, savings, and so forth, where is the financial FDA for this? You know, who is looking at what the aftereffects of these products are? Because it is certainly not Wall Street. They are just looking at their bottom line.

With regard to innovation itself, the exchanges themselves have produced plenty of innovation as well. It has not just come from the over-the-counter market.

So, at any rate, I would just like to get that out, but with regard to liquidity, one of the things that some of the folks that have testified have mentioned is the whole issue on financing cost for corporations, and what many may not realize is that those financing costs are borne by someone. When you buy a swap from someone, the other side of that swap, if it is a large investment bank, those funds are not free.

So all that financing cost that people say, oh, we are going to have financing cost and margin and so forth, you are already paying that if you are an over-the-counter customer to a bank. You just may not see it. In addition, you are paying other things that you may not see, notably, profit margins.

So the issue that we argue with regard to mandatory clearing for standardized derivatives is—I think you would actually lower the costs because you would have more people that would be able to trade with each other with regard to swaps. You would increase the liquidity. You would certainly lower the bid and offer. And so I actually think that, contrary to raising costs for corporations, you would actually lower costs for corporations ultimately.

We had that experiment with the New York Stock Exchange when bid offers went from eighths to quarters and halves to decimals, and volume has tripled and liquidity has tripled. So I think you look at that example and you have a better idea of really what the future could be, and you have many, many more participants in the market, not just investment banks, that are allowing liquidity.

Chairman HARKIN. Excellent point. Thank you.

Mr. Driscoll.

Mr. DRISCOLL. Chairman Harkin, I have been a futures regulator for almost 40 years, and I can tell you that when I first started out—this is sort of the flip side of the innovation angle—there were no such things as interest rate products in the futures markets; there were no stock index products. The whole panoply of products out there that I think everyone, without exception, agrees are very valuable, not only to the futures markets but to the participants in the futures markets and to the American and the worldwide economies. So there obviously is a plus side to innovation.

From the regulatory standpoint, I believe that it is key that all of these markets be subject to a prudent level of regulation. It does not mean that every market has to have exactly the same regulations. Equity securities and futures do not have exactly the same types of regulations. And I think the focus on systemic risk and transparency by Congress, the administration, and the CFTC is exactly the right one.

I am a big proponent of clearing organizations and exchange-traded markets. That is primarily what we regulate. So anything that can be done to encourage moving as much business as feasible onto regulated markets and to have those instruments cleared would be a positive thing, recognizing that I am—and I am not the biggest expert in that area—that I am sure that there are any number of more non-standardized products that would be difficult to put on an exchange.

Thank you.

Chairman HARKIN. Thank you all very much. I took an inordinate amount of time with that, but I yield to my friend Senator Chambliss.

Senator CHAMBLISS. Let me start with you, Mr. Lenczowski. You mentioned in your written testimony that the industry is seeking to clear more credit default swaps. Would you expand on other ongoing efforts to curb systemwide risks relative to CDS in addition to the clearing?

Mr. LENCZOWSKI. Yes, thank you, Senator. Over the past 4 years, the dealers have been working with investors to come up with market improvements for the credit default swap market, and several of those improvements have been made. First, the amount of undocumented trades has been drastically reduced. There have been

protocols agreed as to the way to treat novations or transfers of trades. There has been a huge improvement in the amount of trades that are electronically confirmed, which significantly decreases operational cost.

Then just recently, there has been a major change and restructuring of the way that the market operates so as to standardize cash settlement as the form of settlement of credit derivatives and to standardize all economic terms, essentially, for credit default swaps.

The result is that the product has become standardized to the point where we think that more and more over-the-counter credit default swaps will be cleared. The ICE U.S. Trust Clearinghouse started operation earlier this year already clears over \$800 billion of CDS transactions. That number is going to grow. Old trades are being backlogged into the system to further increase the pervasiveness of clearing. So the entire progression of the market has been toward increasing clearing, increasing transparency, additional recordkeeping and transparency from the standpoint of pricing, prices are now available on the Internet, freely accessible for the largest entities that are traded.

So it has been a steady progress working between dealers and investors, working with the regulators to improve the market.

Senator CHAMBLISS. Does your firm use the ICE OTC clearing?

Mr. LENCZOWSKI. Yes, we do.

Senator CHAMBLISS. How is that working from a practical standpoint?

Mr. LENCZOWSKI. It has been working very well. Again, clearing is distinctly in our interest to do. When the transactions are standardized and when counterparties to our transactions are able to clear, we derive great benefits from clearing. And we have used the ICE clearinghouse for credit default swap clearing, and we also use other clearinghouses for other asset classes. So, for example, in the interest rate swap market, we use the London clearinghouse called LCH Clearnet, which clears a huge volume of interest rate derivative transactions. Something like 50 percent currently of the dealer-to-dealer swaps are cleared. And in the commodity markets, we are clearing through facilities operated both by ICE and by the CME group called ClearPort.

So all this evidence is a move toward clearing. We think it is—amongst the dealers, it is definitely in the interest of everyone to reduce risk, to increase transparency.

Senator CHAMBLISS. There seems to be a perception out there that the only derivatives that need to be customized are the very complex and most complex products. Are there not simple foreign currency or interest rates swaps that still need to be customized for your clients?

Mr. LENCZOWSKI. Yes, absolutely. And actually Chairman Gensler earlier described one of those transactions, a simple interest rate swap which has been around now for almost 30 years, is very well understood, not a complicated transaction at all. But it is extremely customized as to every economic term, and that is to give the end user, the company that is entering into that swap, the maximum hedge for its risks, and also to get the best accounting treatment. An entire accounting framework has grown up around

derivative transactions and hedging transactions, and over-the-counter instruments are the best way for companies to take advantage of that accounting framework.

There is another example I could cite. Chairman Harkin was looking for examples of why something has to be done over the counter. In the natural gas markets, at this point dozens of public utilities engage in long-term natural gas purchase contracts where they are able to procure natural gas at prices below the prevailing market price on a monthly basis for the next 15 to 20 years. These are very long term purchase contracts, and they are able to do that through the use of over-the-counter natural gas and interest rate derivatives. These are contracts that ultimately benefit millions of consumers of natural gas, customers of these utilities. They are well understood. They are approved through the Tax Code amendments passed in 2005, and they serve an incredible benefit to communities throughout the U.S.

Senator CHAMBLISS. There has been a lot of conversation and critique of the markets over the past year with respect to what is called "excessive speculation," and that speculators drove up the physical commodities to record high prices. Now, you deal in the market on a daily basis, I assume sometimes as a speculator, sometimes not. Explain what you see with respect to speculation, why it is necessary and what is happening with regard to this issue of excessive speculation.

Mr. LENCZOWSKI. Yes, Senator. And I might preface it by first saying that we strongly support efforts to combat and prosecute manipulation. Market manipulation is in no one's interest, and certainly from a market participant standpoint, it is extremely detrimental to all of our activities. And—

Senator CHAMBLISS. Obviously, there is a difference between manipulation and speculation.

Mr. LENCZOWSKI. Yes, and speculation is necessary for markets to perform. To take a very basic example, the farmers of this country, when they farm grain, will need to sell it ultimately to bakeries, for example. The baker and the farmer need to match up, one to sell grain, the other to purchase grain. The chances of them matching exactly for all of their purchases are extremely low. Speculators expand each side of that market. They buy and they sell. And they provide the liquidity that is necessary for markets to operate. So all markets require some degree of speculation. Excessive speculation certainly is something to be combated, and we would support that.

Senator CHAMBLISS. Mr. Dines, you deal in the markets every day with respect to risk management tools that you use in your business. I would like for you to give us a practical example of one of these customized contracts that you use. And if those customized contracts were not available to you at Cargill, what effect would that have on your business?

Mr. DINES. Happy to do so. Thank you.

Everyone here knows that Cargill is a processor of corn, and we are in the markets buying corn every day. In essence, we are buying corn at the average price over a given period since we are in buying it every day.

The best hedge for us if we wanted to protect against prices going higher would be a product against the average, not a product against a discrete point in time, which is what you can get on the exchange.

We can go into the OTC markets and buy what is known as an average price option. An average price option comes at a 30-to 40-percent discount to what is available on the exchange. It is a more precise hedge for what we need because it is against the average. It is real cost savings up front, and this cost savings might be the difference between what gets us to hedge and what does not get us to hedge. So that is a real example.

Now, we cannot go in and buy that product on the exchanges. Average price options do not exist. Furthermore, in the OTC markets, we can tailor that product to give us the exact level of protection that we want and for the exact end date that we want. Let us say that we wanted to do it on new crop corn, but we only wanted to go through the pollination period of July. If we went to the exchange, we would have to buy a product that ends in November. We could tailor this product to end in July. We are saving ourselves 4 months of time value of extra cost that goes into that product.

So those are real examples of the types of things that you can do in the over-the-counter market that you cannot do on an exchange-traded type market.

Senator CHAMBLISS. What if that were not available to you? What would be the effect of that unavailability?

Mr. DINES. It would be a far less precise hedge and a more costly hedge, and I know you would find market participants doing less hedging because of the costs.

Senator CHAMBLISS. We talked earlier about position limits and increased margins and what-not, and I think you used the phrase that this could create—would create a real drain on working capital.

From the standpoint of Cargill, do you have any idea of what kind of conceivable working capital drain you would be looking at for the volume that you do business in every day?

Mr. DINES. I think at times it could be significant. I guess maybe I would take you back to last March when we and other grain companies actually had to stop buying deferred grain from farmers, because of the run-up in grain prices and the demands on working capital to cover margins calls. Luckily, we were able to move some of our hedges to the OTC markets where we were able to put in place alternative credit arrangements and become reopened for business. And I think the important point here is that we would like to have the flexibility.

We do plenty of hedging on the exchanges. We do lots of hedging in the over-the-counter markets. The idea for us is that we like to have the flexibility, and that is very, very important for Cargill, but I do not have a number in mind, but I could tell you it would be significant.

Senator CHAMBLISS. Mr. Masters, you have conducted an analysis in which you extrapolated data from CFTC's commitment of trader report to determine speculative activity in the crude oil mar-

ket. Your analysis seems to assign values based upon index fund portfolios.

Now, do you assume that speculative activity was primarily occurring only in the index funds as opposed to the single-name commodities?

Mr. MASTERS. Thank you, Senator. We are assuming that the index funds were a primary participant last year with regard to commodities. There were also speculators in single-name commodities as well. We looked at the index fund data that was provided from the CFTC.

Senator CHAMBLISS. Well, what data is used to support your assessment that oil prices should have been falling last year when most expectations and market analyses showed prices continually increasing throughout the year due to geopolitical uncertainties, record OPEC stocks, a devalued dollar, and the increase in demand during the summer last year?

Mr. MASTERS. That is a good question. The issue with regard to prices in the futures market has to do with the supply and demand of futures. In the grains and the oil markets, the futures price is the price that determines spot, unlike other derivatives, unlike many other markets. You know, Platts, who is the largest spot pricing service, says in part, "We price off futures markets." Many spot market participants we talked to said, "We almost entirely price off futures markets off some basis."

So I think that what we did was we looked at the money flows going in and the money flows going out, and our sense was based on the data that there was an enormous amount of money going into the crude oil markets over the time, and after Congress looked at this issue and I think started really complaining about it to a certain extent, I think it led a great deal of money to come out of those markets, none of which had much to do with actual supply and demand. They amplified the price on the way up, and they greatly amplified the price on the way down.

Senator CHAMBLISS. Mr. Bookstaber, we talked with Chairman Gensler about the responsibility for determining whether or not a product is standardized or customized, and we talked about the clearinghouse that is going to clear it being the determinant of that.

What is your thought about that, are they the proper ones to determine whether something is customized or standard?

Mr. BOOKSTABER. The notion of standardization is a fairly loose one. The key is whether you can construct sufficient tagging for the product so that many other products can be put into the same basket and traded in a similar way. You know, ultimately the decision for standardization will be if it is on an exchange, is it sufficiently different from other products that people gravitate toward it as an item to trade? I do not know who the authority would be to say, oh, this is standard versus this is customized. It is something that still has to be defined.

Senator CHAMBLISS. OK. Mr. Driscoll, in talking about the Zelener fix, as the Chairman says, we had a very significant discussion on this issue last year during the farm bill debate, and we addressed the concerns of the lookalike forex contracts, and I am not sure in your statement that you made earlier, where you said that

there has been an increase in the number of complaints since Congress closed the loophole, whether you are talking about since the farm bill was enacted last year or are you referring to some previous date where a loophole was closed?

Mr. DRISCOLL. I was referring to last year in the farm bill. We have seen a large increase since a year ago today.

Chairman HARKIN. You mentioned gold and silver as commodities where there is the potential for fraudulent transactions. Any other commodities that need to be considered in that same respect?

Mr. DRISCOLL. Precious metals are by far the largest product that is being used in these non-forex Zelener type of contracts, but we have also seen energy type of products as well. And our view is that essentially you have to close the loophole for all commodities that are traded in futures markets because if you close off the ones that are currently existing, then next year we will be coming back and saying the fraudsters have now gone to other markets, because the people that trade these sorts of contracts and run these sorts of schemes are ones that are looking for a regulatory vacuum, and they have made careers of doing this. So we believe the loophole has to be closed for all commodities.

Senator CHAMBLISS. Ms. Stout, do you feel that all OTC markets create a systemic risk?

Ms. STOUT. No, probably not. I think something—that is actually a question that is not even necessarily something we have to address. I think a proper system of regulation of derivatives trading would prevent systemic risk from arising in any particular market. And I personally tend to favor what I think of as automatic circuit breaker rules of this sort rather than regulation that takes the form of creating some omniscient entity, some omniscient Government overseer who is supposed to investigate things on an ad hoc basis and look for potential problems.

I think with the right set of circuit breakers, the sorts that have been mentioned today—listing requirements, margin requirements, position limits—we do not have to worry about looking out for the development of systemic risk in particular markets because the system would look out for us.

Senator CHAMBLISS. Do you agree that some risk in markets is a good thing?

Ms. STOUT. Pardon me while I put on my pointy headed corporate finance professor hat. No, risk is never good. However, sometimes risk is inevitable if you want to accomplish something useful, like curing cancer or building a company that builds airplanes. But, no, risk itself is never good. We would like to get rid of all of it, if we could, and the real trick, I think, is to eliminate all the unnecessary risks while not throwing the baby out with the bath water and eliminating risk in productive areas and with regard to productive endeavors that we want people to undertake.

Senator CHAMBLISS. Well, having been in business myself, I have never made any money without taking a risk, and I just think it is extremely difficult and would be extremely expensive if we tried to take the risk out of it.

Mr. Chairman, I think that may be—I think that is all I had.

Chairman HARKIN. Thank you very much.

Mr. Masters, in your summary, you said, "What I have outlined in my testimony are not brand-new solutions; one, exchange clearing with novation and margin and, two, speculative position limits have proven effective over many decades of experience. In many ways, what we need to do is turn back the clock on several of the deregulatory measures that were undertaken in the last 15 years. The unintended consequences of those deregulatory decisions have been devastating for America." I agree.

Now off of that, I want to challenge you, Mr. Dines, on what you just outlined on this average price option. You say it is not offered by the exchanges. Well, why is it not offered by the exchanges? We have a chicken-and-egg thing here. See, now, I have said we ought to put all these on exchanges, you see. Well, if you are allowed to have them on over-the-counter markets, that is where they are. But who is to say that this average price option could not be developed as a product on a regulated exchange? That way you have more transparency, you would have more people involved, you would have more liquidity because you would have more people in that game. But as long as we have it in the over-the-counter market, with some opaqueness, lack of transparency, of course, the exchange is not going to offer it.

I had Mr. Duffy here last fall when we discussed this very thing, and I asked him that pointed question. I said in terms of my legislation, to put them on a regulated exchange, I asked him very pointedly. I said could your exchange—could the regulated exchange, not just his but the regulated exchanges handle this, and his answer was yes.

So, again, I have always asked, I keep asking this question—I asked two questions. One, define a customized swap. I still have not had one real defined yet, what is customized that does not have some impact someplace in the economy. If you have a customized swap on an interest rate or something like that, it may be between two individuals, but it may have other effects on a lot of other investors in other places. The same way with your hedging on the corn market. It could have a lot of effects.

I would submit that if you have it on a regulated exchange with more transparency and people know about it, quite frankly, I think your business will do better. I, quite frankly, think it will, and I think that the sellers will also do better, too, because it will be open and aboveboard. And we can call for margin requirements. Now, you had this problem with capital requirements. But that can be set. We can temper that, I think, through regulation on not having onerous capital requirements, but having some capital requirements, putting some skin in that game.

So, again, I want to challenge you on why you cannot do this on a regulated exchange.

Mr. DINES. Well, you could put average price options on exchanges. That could very well happen. But the degree of customization goes beyond that, and it goes to protection periods, it goes to protection levels, it goes to maybe how the average is determined. And the issue is that you can have multiple, multiple different variations of an average price option.

I want to be very careful. It does not mean that they are more complex. It means that they are tailored to precisely meet that hedger's needs.

I think it is impossible for the clearinghouses and the exchanges to do this. I do not think they can handle multiple forms, and the OTC market does it. We do it every single day. Our customers will say I want it to expire this particular day, I want it with this protection level, I want the averaging period to start here and end here. And to put that on an exchange will require standardization.

You go into the exchanges today, you can pick from a certain set of end dates. You can pick from a certain level set of protection levels. But you do not have the degree of customization you cannot customize. They just are not set up to do it.

So that I think is the primary difference. It is the ability to really work with customers to customize the product.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. I think a good example of the distinction—the gray area between standardized and customized is the equities option market. The CBOE is, as exchange traded. In that market you cannot get an exercise price of, say, 51.3.

Chairman HARKIN. Say that again? You cannot—

Mr. BOOKSTABER. The exercise prices for the options are in increments, maybe 5- or 10-point increments.

Chairman HARKIN. OK.

Mr. BOOKSTABER. So somebody could argue, wait a minute, this is not fulfilling my objective because I do not want an exercise price of 50 and I do not want an exercise price of 55; I want 52.23.

Well, of course, if you go to customized, the standardization is going to limit things to some extent, but the challenge is to go to Cargill, to go to the clients of JPMorgan, and to say let us look at the whole layout of the customizations that you do. Can we find a reasonable set of standard securities that get close enough to what people want that in the majority of cases they are fairly satisfied? Maybe somebody wants a time to maturity of 11.1 months, and another wants it of 10.9 months; 11 months might do the job for them.

So it is true that you cannot get standardization to meet every of the infinite possible numbers of times to maturity and the infinite number of possible exercise prices. But once you get to fine enough differentiation, that may be sufficient to deal with the large majority of what people demand.

Chairman HARKIN. Mr. Lenczowski.

Mr. LENCZOWSKI. Thank you, Chairman. I would agree with Dr. Bookstaber that there could be a degree of standardization that is achievable. But even with that standardization, the company that is looking to hedge its risk will still have to post the margin to the clearinghouse. And you mentioned, Chairman, that we could maybe regulatorily affect that margin. It is actually incredibly important that that margin be what the clearinghouse says it is because the clearinghouse has to act as the ultimate credit support to everyone. So it sets its margin requirements based on what it feels through its risk models the risk of a particular transaction is.

So the clearinghouse sets that margin requirement, and then it requires the most liquid form of collateral, because as soon as a de-

fault occurs, the clearinghouse has to instantaneously apply that collateral against the defaulted position. There is no ability to wait and sell some property or land. It has to happen instantaneously. Again, that preserves the clearinghouse's stability.

So while, again, I agree that there could be standardization and it could actually suit certain customers' needs, many customers just do not have that liquidity, that cash right now, and that is why, among other reasons they use the OTC market.

I think there was a mention that the OTC market is not collateralized or that it has—that the customers pay for that margin somehow. In fact, many times when these customers go to the OTC market, the collateral that they pledge is the exact same collateral that they have pledged to secure their loan obligations. Many customers borrow on a secured basis. They pledge land or equipment, fixtures, receivables, even intellectual property. That is all good collateral. It is very good. That supports our lending agreement, our money we lend to them.

It serves both as credit support for the loan and also for the derivative, and that is the efficiency and the flexibility that OTC derivatives provide to corporate America. And that is why we think corporate America chooses the OTC markets instead of the exchange markets. It is not because there is anything wrong with the exchange markets. It is just that the OTC markets are more flexible and are able to address exactly the risks that the company wants to hedge.

Chairman HARKIN. Did you have any observation on this at all, Dr. Stout.

Ms. STOUT. No, not on this.

Chairman HARKIN. Dr. Bookstaber.

Mr. BOOKSTABER. If I can just indulge on this, I think this point—of course, it is better if you can post illiquid collateral. Of course, all of us would like to have that. But there is a problem if the instrument is highly liquid and can be liquidated very quickly, and what you have as collateral is very illiquid. This is what leads to liquidity crisis cycles. I have \$800 million that I have as collateral at a bank. I am in a market that for some exogenous reason drops by 10 percent. The bank says, "Come up with more capital, or we will start to liquidate." And suddenly they say, "Oh, but it is land. We cannot liquidate it in the same timeframe as this instrument."

So it is painful and, of course, we do not want to have it be the case, but I think if you have liquid securities, you have to have liquid collateral on the other side.

Mr. LENCZOWSKI. If I could, Chairman, just to respond.

Chairman HARKIN. Sure.

Mr. LENCZOWSKI. The size of our loan book at JPMorgan is roughly 10 times the size of our derivatives exposure, and much of that loan book is supported by this collateral that Dr. Bookstaber mentioned. It is relatively illiquid, but it is excellent quality collateral. We lend on that basis.

So what we allow our customers to do is to use that same collateral to support their derivative transactions. That is useful for them. It is not an unsafe and unsound banking practice. In fact,

our examiners who are onsite would be all over us if it was anywhere close to that.

So I would like to just clarify that this is very good collateral that we are receiving from our customer base and that it is a very big part of what makes these transactions happen for companies.

Chairman HARKIN. Let me ask that, Mr. Lenczowski. So you admit it is not liquid, and how much can that be leveraged? How much can you leverage something that is illiquid that is an asset or land or whatever, how much can you leverage that?

I think I can understand it if it is capital, but I do not know that I can understand it if it something else.

Mr. LENCZOWSKI. That is an excellent point, Chairman Harkin. Our credit officers make that exact determination. We have statistical models and other means of assessing what our probable exposure could be. We use many forms to do that, but we are able to decide from a credit standpoint how much we could do. Again, these determinations are reviewable by our regulators and we ensure that are done within safe banking practices.

Mr. DINES. Chairman Harkin, could I just add to that point for a second? We have probably 250 to 300 institutional type customers that we are providing products to. We margin with about 80 percent of those customers today. We are moving collateral back and forth with them. We are sending them daily position reports so they know what the value of their derivatives are. Again, they know the value. They are moving the collateral back and forth.

They are giving us liquid cash as collateral, or we are giving them liquid cash as collateral. The difference is that we do not think that a highly rated food or industrial company should be held to the same margining terms as a lower-quality, more leveraged company. And so we are flexible in our credit terms for them, so we may not make them post initial margin. We may give them a million-dollar threshold before they need to post margin. But we are still applying very strict credit standards. We are margining with them. But we are flexible in the way that we do that, and that is very, very important. A million dollars to a company today means a lot from an investment standpoint.

So that is the way that we are managing it. That is the benefit of the OTC market versus a standardized exchange, because if you think about the standardized exchange, it has to go for the lowest common denominator, because it is dealing with all sorts of companies all different levels of credit quality. So it has to build its risk, its margining on the worst possible credits that might be part of that clearinghouse or exchange, where in the OTC market you do not have to do that.

Chairman HARKIN. Ms. Stout.

Ms. STOUT. I think the last comment is very helpful for helping keep a perspective on what we are discussing here. You referred to a million-dollar savings today for Cargill. We are dealing with a crisis that I believe the figure that you mentioned this morning, Mr. Chairman, was \$4 trillion. I do not think anyone would dispute that for some businesses at some times, some forms of derivatives are definitely beneficial. I think the critical question has got to be how do we measure the benefits against the harms.

I am very sympathetic. I wish I could ensure that Cargill could always have the perfect hedge. But if maybe you have to inconvenience yourself a little bit and deal with a suboptimal hedge sometimes, and the social benefit we get is that we do not get another Lehman Brothers, another Bear Stearns, another AIG. Well, sometimes you have to put with a little bit of difficulty.

We are at a watershed moment, Mr. Chairman, I think, that is comparable to the situation we faced in the 1930's. Over the past decade, I think we can argue that the finance sector of our economy came close to cannibalizing the real economy. Derivatives were definitely part—not the only part, but one of the larger parts of that cannibalization process.

It is clear that we cannot sustainably go doing things the way we have done them for the last 10 years. You know, the definition of "insanity," doing the same thing and expecting different results. Every time in history in my research that we have attempted to deregulate derivatives, we have gotten the same results.

So on the theory that the perfect is the enemy of the good, any regulatory development that can begin to bring back the exposure that we have today, the exposure to systemic risk, to reduced economic productivity, to price bubbles, to fraud and manipulation, anything that can begin to ratchet that back would be a very good thing.

Chairman HARKIN. Anyone else? Yes, Mr. Masters.

Mr. MASTERS. I just want to make a couple points. With regard to the whole notion of multiple prices, volume-weight average prices, in the equities business we have probably in excess of 100 different ways on listed exchanges of trading those various kinds of orders. We can do algorithms that do all sorts of things that can literally wait every 2 minutes for an order and then only take the offer or sit on the bid all day, or hide or bob or weave or whatever. All those things are possible on listed exchanges. We do them every day in our own business.

Second, I would like to make this point because I think it is important. With regard to the notion of options at different strikes and so forth, we are one of the largest option traders in the United States, listed options, and one of the issues with regard to options is when you trade in over-the-counter option, there is someone on the other side that knows your position. That is a huge issue. I do not want them to know my position because if they know my position and it is just me and him, if something goes wrong I have got a problem, and he knows exactly what my problem is. And that goes on every day.

So there is a huge competitive advantage to a bank or a swaps dealer to have that position on with a customer because they are able to reverse engineer the customer's knowledge and flows. So having that liquidity, having an exchange being able to trade with perfect—being able to hide, if you will, I can trade on these options exchange, and people do not know who I am. And I can trade using various different orders. That is a great benefit, and it would be a great benefit to many other customers once they understand that little dynamic that goes around on Wall Street.

Chairman HARKIN. Pretty interesting.

Yes, Mr. Lenczowski? Then we will have to call this off.

Mr. LENCZOWSKI. Thank you, Mr. Chairman. Just a couple of points.

First, the exchanges have been trading equity options for quite a while now, and they are free for anyone who can open an account there. Certainly we have no desire in monopolizing the equity market in the over-the-counter business, and any customer who feels they will do better on an exchange should trade there and should feel free to trade there. What we do not want is to eliminate that choice from the customer. There are some customers who might choose facing an exchange-traded exact same product to trade in the over-the-counter market. And to that extent, that kind of a choice should be continued to be allowed.

Then, second, just to confirm, there is a straw man argument or some example that the banks are against regulatory reform or swap dealers are against regulatory reform. That is absolutely untrue. We support broadly the initiatives that the administration has announced and Chairman Gensler described today. I have outlined them in our written submission, and I would just like to reassert again that we do agree completely that something has to be done. We just want it done in the right way for the economy.

Chairman HARKIN. Any last words? I thought this was a very enlightening session. We could probably go on for some time. As a matter of fact, I have got Secretary Vilsack over in the Appropriations Committee that I have got to go over and listen to his testimony on his budget.

But as you know, we are wrestling with this, but I guess I end where I started. We cannot continue to do what we have been doing. We have got to make some changes, and there have got to be, I think, some fundamental changes in the way we do this.

Now, I have taken the position, you all know my bill, what I attempted to do in that legislation. However, I am always willing to look at other sides of that issue. But I guess from my own personal standpoint, I still come down to the more open we are, the more transparent we are, the more information that people have out there in a regulatory framework, the better off we are all going to be. And somehow we have got to, as Mr. Masters said, I think, get back to where we were before in some kind of a regulatory framework. And that is what we are going to have to wrestle with, exactly how we do that. No one wants to stifle innovation, as I said, but we have got to ask what that innovation is for.

Second, no one wants to get rid of speculation. We need speculators, but we do not want that bottle of aspirin every day. We just need maybe one. So we have to figure out how we provide that kind of liquidity in some kind of a regulated manner also.

So these are the things we are wrestling with. I think this panel added greatly to our thoughts on this and our pursuit of trying to figure out what we can do. I just would say to all of you that as we proceed on this, any other thoughts and suggestions you may have, please let us know, and we will be developing this legislation some time this year, probably not until this fall. We have the health care bill, and we have got a lot of other things we have to do, and we have to do the child nutrition reauthorization, too, this year. But this is something we have got to attend to, and I have talked to Mr. Peterson on the House side, and he wants to move

something this year, too. So I invite your constant input and consideration of what we are doing here.

Again, I thank you all very much for being here today. As I said, it was a great panel. I appreciate it very much, thank you; the Committee will stand adjourned.

[Whereupon, at 1:29 p.m., the Committee was adjourned.]

A P P E N D I X

JUNE 4, 2009

Statement of Senator Thad Cochran

Senate Committee on Agriculture, Nutrition and Forestry

June 4, 2009

Mr. Chairman, thank you for holding this hearing to review the current structure of futures market oversight and considering testimony about how best to improve transparency. It is critical that these markets remain a viable option for farmers and business operations choosing to hedge risks.

This is a subject that attracted our attention following last year's experience with such a volatile commodity market. This hearing will allow us the opportunity to hear from the Chairman of the Commodity Futures Trading Commission (CFTC) and other experts to learn more about options for increasing market transparency and oversight.

While I agree that more transparency is needed, we must avoid overreaching and eliminating the opportunity for participants to enter

contracts. Production agriculture utilizes these markets to maximize profitability, and I urge the CFTC to use their current authority to address concerns as Congress continues to consider additional legislative action.

I look forward to the testimony of our witnesses.

Testimony of Richard Bookstaber

**Submitted to the Senate of the United States,
Committee on Agriculture, Nutrition, and Forestry
For the Hearing: "Regulatory Reform and the Derivatives Markets"
June 4, 2009**

Mr. Chairman and members of the Committee, I thank you for the opportunity to testify today. My name is Richard Bookstaber. During my career I have worked extensively in risk management. In the 1990's I was in charge of market risk management at Morgan Stanley and then oversaw firm-wide risk at Salomon Brothers, continuing in that capacity for a short time after it was absorbed by Citigroup. Following that, I oversaw risk at two buy-side firms, Moore Capital Management and Ziff Brothers Investments, and ran an equity hedge fund at FrontPoint Partners. Most recently I worked at Bridgewater Associates, a large hedge fund headquartered in Westport, Connecticut. I left Bridgewater at the end of 2008.

Before working in risk management, I was one of the pioneers in the development of derivative products on Wall Street. Moving from academics to Morgan Stanley in 1984, I designed, priced and hedged derivatives, and had experience with derivatives in the equity, fixed income, commodity and foreign exchange markets. I wrote one of the first books on derivatives, *Option Pricing and Strategies in Investing*, (Addison-Wesley, 1981).

I am the author of *A Demon of Our Own Design – Markets, Hedge Funds, and the Perils of Financial Innovation*. Published in April, 2007, this book warned of the potential for financial crisis from the explosion of derivatives and other innovative products.

Although I have had extensive experience on both the buy-side and sell-side, I come before the Committee in an unaffiliated capacity, and represent no industry interests.

My testimony will focus on the need for reduced complexity and increased transparency in the derivatives markets. This can be accomplished by standardization of derivative instruments and ultimately by having derivatives trade on the exchange. Many of the issuers and users of derivatives have incentives for derivatives to remain complex and opaque, but these incentives are related to flawed objectives.

Complexity: The Problem with Derivatives

Derivative instruments – and I use the term broadly to include the swath of what are often termed ‘innovative products’ such as options, swaps and structured products – can improve the financial markets. They can allow investors to mold returns to better meet their investment objectives, to more precisely meet the contingencies of the market. They can break apart and package risks to facilitate risk sharing. In the parlance of academic finance, they allow investors to better span the space of the states of nature. These objectives were the focus in the nascent years of derivatives, in the decade or so after the development of the Black-Scholes-Merton option pricing methodology and the establishment of the Chicago Board Options Exchange.

As time progressed, however, derivatives found use for less lofty purposes. Derivatives have been used to solve various non-economic problems, basically helping institutions game the system in order to:

- Avoid taxes. For example, investors use total return swaps to take positions in UK stocks in order to avoid transactions taxes.
- Take exposures that are not permitted in a particular investment charter. For example, index amortizing swaps were used by insurance companies to take mortgage risk.
- Speculate. For example, the main use of credit default swaps is to allow traders to take short positions on corporate bonds and place bets on the failure of a company.
- Hide risk-taking activity. For example, derivatives provide a means for obtaining a leveraged position without explicit financing or capital outlay and for taking risk off-balance sheet, where it is not as readily observed and monitored. Derivatives

also can be used to structure complex risk-return tradeoffs that are difficult to dissect.

These non-economic objectives are best accomplished by designing derivatives that are complex and opaque, so that the gaming of the system is not readily apparent.¹

Viewed in an uncharitable light, derivatives and swaps can be thought of as vehicles for gambling; they are, after all, side bets on the market. But these side bets can pose risks that extend beyond losses to the person making the bet. There are a number of ways the swaps and derivatives end up affecting the market:

- Those who create these products need to hedge in the market, so their creation leads to a direct affect on the market underlying the derivative.
- Those who buy these instruments have other market exposures, so that if they are adversely affected by the swaps or derivatives, they might be forced to liquidate other positions, thereby transmitting a dislocation from one market into another.
- The market price of some derivatives can have real effects for a company. For example, the credit default swaps are used as the basis for triggering debt covenants, so if the swap spread for a company's debt rises above a critical level, it can have an adverse effect on the company. Indeed, a dislocation in the credit default swap market can have a more immediate and severe effect on a company than will a dislocation in its stock price, because the credit default swap spread has an impact on the ability of the company to obtain financing.²

¹ For example, the last point, hiding risk-taking activity, is facilitated by the opacity of the risk-return tradeoff for derivatives. Any derivatives trader worth his salt can construct a derivatives position that will seemingly print money, in all likelihood generate cash flow month after month, but will get that cash flow by taking on a subtle risk which will rarely be realized, but when realized will have a profound negative effect. Without proper modeling, this risk will not be manifest until it is too late. This means that derivatives are the weapon of choice for investors who are faced with a need to book immediate gains.

It also means derivatives are a quick sale to naive investors. There is no need to look back to P&G or Orange County for examples of this. I recently gave a talk to a group of central bankers from small countries, a number of whom had been pitted with derivatives called dual currency swaps, though these were really options that gave the countries a payout in the worse performing of two currencies. In exchange for taking this relative currency risk, the countries received an incremental return of a few basis points. I did not do the calculation, but my bet is that this incremental return left a substantial buffer for the banks that sold the swaps. And that the countries entered into the swaps without recognizing the level of risk they were taking on.

² For this reason, there needs to be strict oversight of credit default swaps to guard against manipulation. Such oversight is far easier for if they are traded on an exchange.

- Derivatives can change the behavior of the market. For example, when various bonds are packaged into Collateralized Debt Obligations, they become linked in a way that they might not be absent this packaging. As a result, the diversification potential within the market can be lower and the potential for contagion between market segments can increase.
- Those who are writing OTC derivatives are in effect providing insurance to the buyers, but without any regulatory requirements on minimum capital. Those writing these instruments may not be in a well-capitalized position to pay out in the event that the option goes into the money.

Regulation of Derivatives

Standardization and Exchange Trading

As I point out in *A Demon of Our Own Design*, complexity is one of the demons that makes our financial markets crisis prone. Complexity hides risks and creates unexpected linkages between markets. Derivatives are the primary source of this complexity, so to reduce the risk of crisis we must address the derivatives markets. We need a flight to simplicity.

The proposal for a centralized clearing corporation, while a welcome step, is not sufficient to do this. It may reduce counterparty concerns, but it will not provide the necessary level of standardization, transparency, price discovery and liquidity. To do that, we need to have standardized derivative products, and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in the transparency and efficiency, and will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivative-induced complexity have created.

Nonstandard OTC Derivatives and Innovation

One stated objection to standardization and exchange trading is that if a door remains open for complex OTC derivatives, then having the standardized products out in the light

of day will only accentuate the demand for the more shadowy and opaque products. An opposing objection is that the push toward standardization will squelch innovation in the financial markets. These concerns lead to demands by some to abolish all OTC derivatives, and by others to shrink from exchange trading. There is no need to move toward either of these two extremes.

Abolishing OTC derivatives is not a wise direction for regulation. There will be legitimate reasons for customized derivatives, and no doubt innovations will emerge with broad value to the financial markets. The point is not to stifle innovation, but to assure it is directed toward an economic rather than gaming end. Nor need exchange trading move activity into the shadows. Properly executed, we can have a combination of standardized exchange-traded instruments along with the continued development of customized OTC instruments.

Standardized exchange-traded derivatives will create high hurdles for any nonstandard OTC product a bank wants to push into the market. The OTC product will have worse counterparty characteristics, be less liquid, have a higher spread, and have inferior price discovery. To overcome these disadvantages, the nonstandard OTC product will have to demonstrate substantial improvement in meeting the needs of the investor compared to the standardized product.

In addition, stricter control and disclosure can be placed on nonstandard OTC derivatives both through investor demand and by regulatory mandate. Investors may demand that derivatives taken on their behalf be of the standardized exchange-traded form, or may require that if a nonstandard alternative is employed, it first be approved by the firm's risk manager. The regulator may mandate the disclosure of such derivatives positions and require a demonstration of how these instruments are being used and why they are being used in place of the standard instruments.³ The disclosure might be public – investment

³ The argument here is not for case-by-case approval of nonstandard products, nor for a regulator to dictate which derivatives can be traded OTC. The regulator does not have to make a determination that any one derivative is being employed for bona fide hedging purposes, or that the use of an OTC derivative is in some sense legitimate. By having on-going disclosure and justification, the investors and the regulators can see emerging patterns of abuse. There will be a point where a firm's use of the nonstandard products will move beyond the norm and will start to draw questions.

firms could justifiably balk at such disclosure now, but that justification is lessened if the firms have the choice of employing exchange-traded derivatives to avoid the disclosure – or, alternatively, the disclosure can be restricted only to the regulator.⁴

Even with these hurdles, there will still be the opportunity for innovation and for the application of the more complex derivatives where their value is compelling. But I believe we will not find many instances where a complex OTC derivative is pushed forward, because for most legitimate purposes the standardized products will be found to be adequate.

Incentives for Creating Complex OTC Derivatives

The current proposal for moving derivatives onto an exchange reminds me of a similar effort I made shortly after I arrived at Morgan Stanley twenty-five years ago. I proposed a simplified structure that would have allowed the interest rate swaps that were traded at the time to be replaced by a handful of standardized instruments. I met with the head of the swap desk and others running the Fixed Income Division to propose that this structure be put forward to allow exchange trading of swaps. I thought the proposal, which would have made the markets more transparent, liquid and efficient, would be greeted warmly, even enthusiastically. Was I wrong. I had yet to appreciate the incentives the industry has to make derivatives as complex and ‘one-off’ as possible.

For the bank, the more complex and custom-made the instrument, the greater the chance the bank can price in a profit, for the simple reason that investors will not be able to readily determine its fair value. And if the bank creates a customized product, then it can also charge a higher spread when an investor comes back to trade out of the product. For

The disclosure could include standardized tagging of positions that will facilitate aggregation and analysis. In this regard, see “Mapping the Market Genome”, <http://rick.bookstaber.com/2009-02/markup-languages-and-mapping-market.html>.

⁴ Disclosure of exposures in a form that allows aggregation across firms is critical for systemic risk regulation. As it stands now, we do not have the ability to sort through the web of counterparty risk or the extent of leverage and crowding in markets. The required data is readily accessible by the regulator for exchange-traded positions, but more aggressive disclosure is required to obtain these data for OTC positions. On the need for disclosure for systemic risk management, see *Testimony of Richard Bookstaber, Submitted to the Senate of the United States, Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment, for the Hearing: “Risk Management and Its Implications for Systemic Risk”, June 19, 2008.*

the trader, the more complex the instrument, the more leeway he has in his operation, because it will be harder for the bank to measure his risk and price his book.⁵ And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic objectives they might have in mind.

These incentives explain why there is an ongoing arms race in innovative products and why the financial institutions might have to be pulled less than willingly into any initiative to standardize derivatives or to move derivatives from over-the-counter onto an exchange.

Conclusion: The Pace of New Regulation

We should move toward standardization and exchange trading of derivatives. We should do this because it is the reasonable direction to take, not as a reaction to the current crisis, and not predicated on whether derivatives did or did not behave in any particular way, or whether they were villains or innocent bystanders. The role played by the current crisis is to provide the impetus for action, for making improvements to the derivatives market independent of the final verdict that history passes down with respect to these recent, tumultuous years.

The arguments for standardization and exchange trading of derivatives are compelling. But there remains much we do not know. Therefore it is important to move slowly, one market at a time; learning by doing rather than pushing for quick, wholesale solutions. Because there are markets that are beyond the purview of the CFTC, indeed beyond our borders, the natural pace will be a gradual one.

⁵ This suggests compensation should be withheld until a derivatives position is closed out and the profit is realized.



Testimony

Before the Senate Agriculture Committee

On

Regulatory Reform and Derivatives Markets

June 4, 2009

**Mr. David Dines, President
Cargill Risk Management**



My name is David Dines, President of Cargill Risk Management. I am testifying on behalf of Cargill, Incorporated and have been in the hedging and risk management services industry for 15 years.

I want to thank you for the opportunity to testify today.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient, competitive, and well-functioning futures markets and over-the-counter (OTC) markets.

Cargill is an extensive end-user of derivatives products, and is also active in offering risk management products and services to commercial customers and producers in the agriculture and energy markets.

One of the major challenges for policymakers and regulators is that the term "over-the-counter market" covers a vast array of products across a number of markets.

This broad definition highlights why it is extremely difficult to seek a one size fits all regulatory or legislative solution that still allows all interested parties to manage their genuine economic risks.

- **One major concern with the recent proposal by the US Treasury Department is that it appears to seek a regulatory solution for *all* OTC products in response to systemic risk posed by one particular market: credit default swaps.**

It is important to note that while we have witnessed the greatest economic crisis in 80 years, and perhaps the most volatile commodity market Cargill has ever seen, OTC contracts in the agriculture, energy, and foreign exchange markets performed well, did not create systemic risks, and in fact helped many end-users manage and hedge their risks during this very difficult time.

For the purposes of our testimony today relative to the US Treasury proposal, we will focus our comments on two categories of OTC products where Cargill is an active market participant:

- Agriculture and energy products
- Foreign exchange products

The Treasury proposal seeks to achieve four broad objectives:

1. Prevent Activities Within the OTC Markets from Posing Risk to the Financial System
2. Promoting Efficiency and Transparency Within the OTC Markets
3. Preventing Market Manipulation, Fraud, and Other Market Abuses
4. Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

We support these stated objectives and believe that steps can be taken to meet these goals, without denying end-users' access to an effective and competitive market. While we have not seen the specific details of the Treasury Department's proposal, we offer these observations based on the information available under each of the specific objectives.

Objective 1: Prevent Activities Within the OTC Markets from Posing Risk to the Financial System



The Treasury Department's outline seeks to apply mandatory clearing of all standardized contracts, impose robust margin requirements, including initial margin requirements for both standardized and customized contracts.

- The imposition of mandatory clearing and mandatory margining of tailored hedges will have a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies who have taken conservative business approaches and choose to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital requirements.
- The potential magnitude of this drain on working capital should be carefully weighed by all policymakers. Cargill is a member of the National Association of Manufacturers (NAM) and has worked closely with a coalition of NAM members concerned about the ability of end-users to efficiently access the OTC market.

I would like to submit for the record a letter from the NAM on this issue, as well as a recent letter from Chesapeake Energy, an Oklahoma-based end user of OTC derivatives and the largest independent producer of US natural gas.

The Chesapeake Energy letter provides an excellent example of how restricting access to credit by imposing mandatory margining could severely drain capital that could otherwise be invested to grow a business. In the one example provided here, over \$6 billion would have been taken away from running and expanding a job-creating business, and instead be left idle in a margin account until the maturation of the OTC contract. While not posting cash, Chesapeake had pledged collateral valued at more than \$11 billion to secure their derivative counterparties.

Expand this example across all of the businesses that use OTC products and the amount of capital diverted from growing the US economy would be severe, unless companies reduced their hedging and risk management.

- There is a misconception that OTC products do not have credit provisions, and are never collateralized or margined. A significant number of OTC transactions are collateralized or margined with collateral being moved daily to adjust for the change in market value. With futures, margining terms are standardized across all participants, while in the OTC markets credit and collateral terms vary and are set according to the credit quality of the hedger.
- With regard to mandatory clearing of standardized products, defining which products are "standard" and which products are "customized" is a complex issue that must be thoroughly examined by the appropriate federal regulator to avoid disrupting market segments that continue to perform well.
- The loss of tailored hedging tools will greatly impact the ability of companies to comply with current accounting standards (Financial Accounting Standard 133). This accounting policy requires hedges to precisely match the underlying risk in order to reduce income volatility.



The Treasury Department outline also indicates that substantial capital requirements could be placed on all OTC dealers.

- While some level of capital requirements might be appropriate, there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers. The agriculture and energy hedging sectors both have active non-financial institution OTC dealers who offer healthy competition in the market. No non-financial institution dealers have required any taxpayer-based financial assistance from the Federal government. It would be inappropriate to eliminate these competitors from the OTC market through legislative or regulatory action.

Recommendation: Regulatory requirements should be based on risk to the financial system and not one-size-fits-all.

Additional monitoring and transparency in the OTC markets (agriculture, energy, foreign exchange, and interest rates) is warranted and Cargill supports these efforts, but restricting working capital through major increases in mandatory margining in these markets is counterproductive.

Improved monitoring and transparency accomplishes the goals for the objective, without the increased expense and capital demands of clearing.

Objective 2: Promoting Efficiency and Transparency Within the OTC Markets

The Treasury Department's outline seeks to impose more recordkeeping and force trades on to regulated exchanges.

Recommendation: More record keeping and better disclosure would be helpful, although the regulator should be directed to focus on areas with the greatest risks.

As previously mentioned, mandatory movement of activities from the OTC market to an exchange-traded market does not seem warranted in those markets that have not created systemic risks to the financial system.

Objective 3: Preventing Market Manipulation, Fraud, and Other Market Abuses

The Treasury Department's outline seeks clear authority to police fraud, market manipulation, and other market abuses and the authority to set position limits on OTC derivatives that affect a significant price discovery function with respect to futures markets.

Recommendation: We support the CFTC having clear authority to police fraud, manipulation and other abuses.

The Commodity Futures Trading Commission is already using its existing authority and is receiving public comment on an Advance Notice of Proposed Rulemaking to address the enforcement of position



limits, address concerns about excess speculation, and help maintain the integrity of price discovery in the futures markets.

Cargill filed public comments with the CFTC on this proposal. In our comments, we support:

- Position limits for non-commercials
- Much greater transparency and reporting for over-the-counter markets.

A graphical summary, including the highlights of the comments, is included at the end of today's testimony as Appendix A. The entire comments are on file with the CFTC, and we would be happy to distribute them to members of the Senate Agriculture Committee.

Objective 4: Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

Recommendation: Products should be marketed and continue to be available to those parties who meet the current regulatory parameters as eligible market participants.

Summary:

1. Derivatives play an important role in helping companies manage risks. Exchange-traded derivatives are essential in price discovery and help facilitate basic risk management, while over-the-counter derivatives are essential to hedgers because they can be customized to fit a company's specific risk management needs.
2. Additional legislative and regulatory actions in the OTC market should:
 - a. Be risk-based, and not treat all products identically
 - b. Improve transparency and reporting
 - c. Seek to add minimal costs and disruptions to those products that have not posed systemic risks to the financial system
3. Mandatory clearing and margining:
 - a. Would severely reduce hedging activity
 - b. Would greatly restrict working capital at a time when it is in very short supply
 - c. Is not warranted for OTC products that have not created systemic risk
4. The CFTC, through its existing rule-making, is proposing much-needed steps and should continue to work on:
 - a. Ensuring the enforcement of position limits in related exchange-traded markets, principally agriculture and energy products
 - b. Improving the transparency and reporting of OTC products

We appreciate the opportunity to testify today and look forward to working with the Members of the Senate Agriculture Committee and other policymakers as this issue develops.



Appendix A:

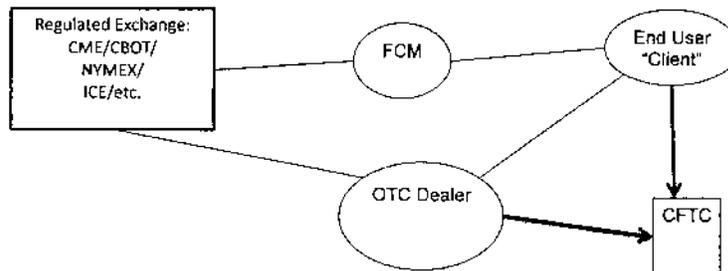
**CFTC Advance Notice of Proposed Rulemaking:
Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and
Create a New Limited Risk Management Exemption from Speculative Position Limits**

Highlights of Cargill's Suggested Changes as Outlined in Comments on CFTC Concept Release:

1. OTC dealer reporting to the CFTC once clients reach a significant size
 - Ensures compliance with exchange-related position limits
2. End user reporting to the CFTC once their activity reaches a significant size
 - Greater transparency
 - Ensures that if multiple dealers are used, the regulator knows the activity
 - Similar to Large Trader Position Reporting requirement
3. *Bona Fide* hedge definition limited to those physically involved with underlying commodity
4. OTC exemption that allows OTC dealers to facilitate customer transactions. A speculative position limit would apply if a dealer is trading on its own behalf, and not addressing client risk.

Graphical Summary of Recommended Changes:

Bold (Blue) Lines Indicate New Reporting/Compliance





**TESTIMONY OF DANIEL A. DRISCOLL
EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE
COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
UNITED STATES SENATE**

JUNE 4, 2009

My name is Daniel Driscoll, and I am Executive Vice President and Chief Operating Officer of National Futures Association. Thank you Chairman Harkin and members of the Committee for this opportunity to appear here today to present our views on closing a regulatory gap that allows fraudsters to sell unregulated OTC derivatives to retail customers.

Since 1982, NFA has been the industry-wide self-regulatory organization for the U.S. futures industry, and in 2002 it extended its regulatory programs to include retail over-the-counter forex contracts. NFA is first and foremost a customer protection organization, and we take our mission very seriously.

Congress is currently expending significant time and resources to deal with systemic risk and to create greater transparency in the OTC derivatives markets. Those are important economic issues, and we support Congress' efforts to address them. Understandably, most of the debate centers around instruments offered to and traded by large, sophisticated institutions. However, there is a burgeoning OTC derivatives market aimed at unsophisticated retail customers, who are being victimized in a completely unregulated environment.

For years, retail customers that invested in futures had all of the regulatory protections of the Commodity Exchange Act. Their trades were executed on transparent exchanges and cleared by centralized clearing organizations, their brokers had to meet the fitness standards set forth in the Act, and their brokers were regulated by the CFTC and NFA. Today, for too many customers, none of those protections apply. A number of bad court decisions have created loopholes a mile wide, and retail customers are on their own in unregulated, non-transparent OTC futures-type markets.

The main problem stems from a Seventh Circuit Court of Appeals decision in a forex fraud case brought by the CFTC. In the *Zelener* case, the District court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures, and the Seventh Circuit affirmed that decision. The "rolling spot" contracts in *Zelener* were marketed to retail customers for

purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In *Zelener*, though, the Seventh Circuit ignored these characteristics and based its decision on the terms of the written contract between the dealer and its customers. Because the written contract in *Zelener* did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures. As a result, the CFTC was unable to stop the fraud.

Zelener created the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals could sell retail customers forex contracts that looked like futures, acted like futures, and were sold like futures and could do so outside the CFTC's jurisdiction. For a short period of time, *Zelener* was just a single case addressing this issue. Since 2004, however, various Courts have continued to follow the Seventh Circuit's approach in *Zelener*, which caused the CFTC to lose enforcement cases relating to forex fraud.

A year ago, Congress closed the loophole for forex contracts. Unfortunately, the rationale of the *Zelener* decision is not limited to foreign currency products. Customers trading other commodities—such as gold and silver—are still stuck in an unregulated mine field. It's time to restore regulatory protections to all retail customers.

Back in 2007, NFA predicted that if Congress plugged the *Zelener* loophole for forex but left it open for other products, the fraudsters would simply move to *Zelener*-type contracts in other commodities. That's just what has happened. We cannot give you exact numbers, of course, because these firms are not registered. Nobody knows how widespread the fraud is, but we are aware of dozens of firms that offer *Zelener* contracts in metals or energy. Recently, we received a call from a man who had lost over \$600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints and mounting customer losses involving these products since Congress closed the loophole for forex.

NFA and the exchanges have previously proposed a fix that would close the *Zelener* loophole for these non-forex products. Our proposal codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*, which was the accepted and workable state of the law until *Zelener*. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts unless delivery is made within seven days or the retail customer has a commercial use for the commodity. This presumption is flexible and could be overcome by showing that delivery actually occurred or that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity.

This statutory presumption would not affect the interbank currency market dominated by institutional players, nor would it affect regulated instruments like securities and banking products. It would also not apply to those retail forex contracts

that are already covered (or exempt) under Section 2(c). It would, however, effectively prohibit leveraged non-forex OTC contracts with retail customers when those contracts are used for price speculation and do not result in delivery.

I should note that NFA's proposal does not invalidate the 1985 interpretive letter issued by the CFTC's Office of General Counsel, which Monex International and similar entities rely on when selling gold and silver to their customers. That letter responded to a factual situation where the dealer purchased the physical metals from an unaffiliated bank for the full purchase price and left the metals in the bank's vault. The dealer then turned around and sold the gold or silver to a customer, who financed the purchase by borrowing money from the bank. Within two to seven days the dealer received the full purchase price and the customer received title to the metals. In these circumstances the metals were actually delivered within seven days, so the transactions would not be futures contracts under NFA's proposal.

In conclusion, while NFA supports Congress' efforts to deal with systemic risk and create greater transparency in the OTC markets, Congress should not lose sight of the very real threat to retail customers participating in another segment of these markets. This Committee can play a leading role in protecting customers from the unregulated boiler rooms that are currently taking advantage of the *Zelener* loophole for metals and energy products. We look forward to further reviewing our proposal with Committee members and staff and working with you in this important endeavor.

**STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
June 4, 2009**

Good morning Chairman Harkin, Ranking Member Chambliss, and Members of the Committee. Thank you for your unanimous vote of confidence on my recent confirmation and for inviting me to testify. I am here today testifying on behalf of the Commission.

The topic of this hearing is of utmost importance during this crucial time for our economy. We must urgently enact broad reforms to regulate over-the-counter (OTC) derivatives. Such reforms must comprehensively regulate both derivative dealers and the markets in which derivatives trade. This is vitally important for the future of our economy and the welfare of the American people. I pledge to work closely with this Committee and the Congress on these reforms to build and restore confidence in our financial regulatory system.

In addition to working toward this much needed reform, I also will work to ensure that the Commodity Futures Trading Commission (CFTC) continues to fulfill its basic mission under the Commodity Exchange Act (CEA) to protect the integrity of the futures markets. I look forward to working with you to improve the capabilities and authorities of the CFTC to ensure that both our futures markets and the OTC derivatives markets are transparent and free from fraud, manipulation and other abuses.

Comprehensive Regulatory Framework

A comprehensive regulatory framework governing OTC derivative dealers and OTC derivative markets should apply to all dealers and all derivatives, no matter what type of derivative is traded or marketed. It should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, it should apply to the dealers and derivatives no matter what type of swaps or other derivatives may be invented in the future. This framework should apply regardless of whether the derivatives are standardized or customized.

A new regulatory framework for OTC derivatives markets should be designed to achieve four key objectives:

- Lower systemic risks;
- Promote the transparency and efficiency of markets;
- Promote market integrity by preventing fraud, manipulation, and other market abuses, and by setting position limits; and
- Protect the public from improper marketing practices.

To best achieve these objectives, we must implement two complementary regulatory regimes: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves – including regulated exchanges, electronic trading systems and clearing houses. Only with these two complementary regimes will we ensure that federal regulators have full authority to bring transparency to the OTC derivatives world and to prevent fraud, manipulation, other types of market abuses, as well as to impose position limits to prevent the

burdens of excessive speculation. These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved.

Regulating Derivatives Dealers

I believe that we must explicitly regulate the institutions that deal in derivatives. In addition, regulations should cover any other firms whose activities in these markets can create large exposures to counterparties.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. The AIG subsidiary that dealt in derivatives – AIG Financial Products – for example, was not subject to any effective regulation. The derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks were not subject to mandatory regulation either.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we can oversee and regulate the entire derivatives market. I believe that the Commodity Exchange Act should be amended to provide for the registration and regulation of all derivative dealers.

The full, mandatory regulation of all derivatives dealers would represent a dramatic change from the current system in which some dealers can operate with limited or no effective oversight. Specifically, all derivative dealers should be subject to capital requirements, initial margining requirements, business conduct rules and reporting and recordkeeping requirements. Standards that already apply to some dealers, such as banking entities, should be strengthened and made consistent, regardless of the legal entity where the trading takes place.

Capital and Margin Requirements. The Congress should explicitly require regulators to promulgate capital requirements for all derivatives dealers. Imposing prudent and conservative capital requirements, and initial margin requirements, on all transactions by these dealers will help prevent the types of systemic risks that AIG created. No longer would derivatives dealers or counterparties be able to amass large or highly leveraged risks outside the oversight and prudential safeguards of regulators.

Business Conduct and Transparency Requirements. Business conduct standards should include measures to both protect the integrity of the market and lower the risk (both counterparty and operating) from OTC derivatives transactions.

To promote market integrity, the business conduct standards should include prohibitions on fraud, manipulation and other abusive practices. These standards also should require adherence to position limits established by the CFTC on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

Business conduct standards should ensure the timely and accurate confirmation, processing, netting, documentation, and valuation of all transactions. These standards for “back office” functions will help reduce risks by ensuring derivative dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

Derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories complement central clearing by

providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions, and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the information recorded meets regulatory needs and that the repositories have strong business conduct practices.

The application of these business conduct standards and the transparency requirements will enable regulators to have timely and accurate knowledge of the risks and positions created by the dealers. It will provide authorities with the information and evidentiary record needed to take any appropriate action to address such risks and to protect and police market integrity. In this regard, the CFTC should have clear, unimpeded oversight and enforcement authority to prevent and punish fraud, manipulation and other market abuses.

Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public. No longer should the public be in the dark about the extensive positions and trading in these markets. This public information will improve the price discovery process and market efficiency.

Regulating Derivatives Markets

In addition to the significant benefits to be gained from broad regulation of derivatives dealers, I believe that additional safety and transparency must be afforded by regulating the derivative market functions as well. We should require that all derivatives that can be moved

into central clearing be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing and trading on exchanges or through regulated electronic trading systems will promote transparency and market integrity and lower systemic risks. To fully achieve these objectives, we must enact both of these complementary regimes. Regulating both the traders and the trades will ensure that we cover both the actors and the actions that may create significant risks.

Exchange-trading and central clearing are the two key and related components of well-functioning markets. Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearing houses for that market should continue as we extend regulations to cover the OTC derivatives market. In implementing these responsibilities it may be appropriate as well to consider possible additional information and other requirements of any systemic risk regulator that may be established by Congress.

Central Clearing. Central clearing should help reduce systemic risks in addition to the benefits derived from comprehensive regulation of derivatives dealers.

Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks. Currently, most of the contracts entered into in the OTC derivatives market are not cleared, and remain as bilateral contracts between individual buyers and sellers. In contrast, when a contract between a buyer and seller is submitted to a clearinghouse for clearing, the

contract is “novated” to the clearinghouse. This means that the clearinghouse is substituted as the counterparty to the contract and then stands between the buyer and the seller.

Clearinghouses then guarantee the performance of each trade that is submitted for clearing. Clearinghouses use a variety of risk management practices to assure the fulfillment of this guarantee function. Foremost, derivatives clearinghouses would lower risk through the daily discipline of marking to market the value of each transaction. They also require the daily posting of margin to cover the daily changes in the value of positions and collect initial margin as extra protection against potential market changes that are not covered by the daily mark-to-market. These practices are similar to the way clearinghouses for futures exchanges operate.

The regulations applicable to clearing should require that clearinghouses establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Working with Congress, we should consider possible amendments to the CEA to expand and deepen the core principles that registered derivatives clearing organizations must meet to achieve these goals to both strengthen these systems and to reduce the possibility of regulatory arbitrage. Clearinghouses should have transparent governance arrangements that incorporate a broad range of viewpoints from members and other market participants.

Central counterparties should also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm. Additionally, central clearinghouses should implement rules that allow indirect participation in central clearing. By novating contracts to a central clearinghouse

coupled with effective risk management practices, the failure of a single trader, like AIG, would no longer jeopardize all of the counterparties to its trades.

One of the lessons that emerged from this recent crisis was that institutions were not just “too big to fail,” but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled.

Exchange-trading. Beyond the significant transparency afforded the regulators and the public through the record keeping and reporting requirements of derivatives dealers, market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated transparent electronic trading systems. Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. A complete audit trail of all transactions on the exchanges or trade execution systems should be available to the regulators. Through a trade reporting system there should be timely public posting of the price, volume and key terms of completed transactions. This system might be similar to the Trade Reporting and Compliance Engine (TRACE) system currently required for timely reporting in the OTC corporate bond market.

The CFTC also should have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation and other abuses.

In contrast to long established on-exchange futures markets, there is a need to encourage the further development of exchanges and electronic trading systems for OTC derivatives. In order to promote this goal and achieve market efficiency through competition, there should be sufficient product standardization so OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another.

Position Limits. Position limits must be applied consistently across all markets, across all trading platforms, and exemptions to them must be limited and well defined. The CFTC should have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market.

Over the past few years, price spikes and unprecedented volatility in the commodity markets have hurt farmers, consumers and businesses. Record-high prices have not only inflicted costs upon American consumers and businesses, but record-high volatility has impaired the ability of many farmers and other businesses to use the futures markets to manage their price risks. As Chairman, I intend to ensure that the CFTC vigorously protects the integrity of the price discovery process in the futures markets and protects the public against fraud, manipulation and other abuses. I intend to ensure the agency does all it can to prevent excessive speculation from causing an undue burden on interstate commerce.

Standardized and Customized Derivatives

It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated. Regulations should also ensure that customized derivatives are not used solely as a means to avoid the clearing requirement. We will accomplish this in two ways. First, regulators should be given full authority to prevent fraud, manipulation and other abuses and to impose recordkeeping and transparency requirements with respect to the trading of all swaps, including customized swaps. Second, we must ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.

One way to ensure this would be to establish objective criteria for regulators to determine whether, in fact, a swap is standardized. For example, there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearinghouse, then it should be required to be cleared. Additional potential criteria for consideration in determining whether a contract should be considered to be a standardized swap contract could include:

- The volume of transactions in the contract;
- The similarity of the terms in the contract to terms in standardized contracts;
- Whether any differences in terms from a standardized contract are of economic significance; and
- The extent to which any of the terms in the contract, including price, are disseminated to third parties.

Criteria such as these could be helpful in ensuring that parties are not able to avoid the requirements applicable to standardized contracts by tweaking the terms of such contracts and then labeling them “customized.”

Regardless of whether an instrument is standardized or customized, or traded on an exchange or on a transparent electronic trade execution system, the CFTC should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation and other market abuses. No matter how the instrument is traded, the CFTC also should have clear, unimpeded authority to impose position limits, including aggregate limits, to prevent excessive speculation. A full audit trail should be available to the CFTC and other Federal regulators.

Authority

To achieve these goals, the Commodity Exchange Act should be amended to provide the CFTC with positive new authority to regulate OTC derivatives. The term "OTC derivative" should be defined, and the CFTC should be given clear authority over all such instruments. To the extent that specific types of OTC derivatives might best be regulated by other regulatory agencies, care must be taken to avoid unnecessary duplication and overlap.

As we enact new laws and regulations, we should be careful not to call into question the enforceability of existing OTC derivatives contracts. New legislation and regulations should not provide excuses for traders to avoid performance under pre-existing, valid agreements or to nullify pre-existing contractual obligations.

Achieving the Four Key Objectives

Overall, I believe the complimentary regimes of dealer and market regulation would best achieve the four objectives outlined earlier. As a summary, let me review how this would accomplish the measures applied to both the derivative dealers and the derivative markets.

Lower Systemic Risk. This dual regime would lower systemic risk through the following four measures:

- Setting capital requirements for derivative dealers;
- Creating initial margin requirements for derivative dealers (whether dealing in standardized or customized swaps);
- Requiring centralized clearing of standardized swaps; and
- Requiring business conduct standards for dealers.

Promote Market Transparency and Efficiency. This complementary regime would promote market transparency and efficiency by:

- Requiring that all OTC transactions, both standardized and customized, be reported to a regulated trade repository or central clearinghouses;
- Requiring clearinghouses and trade repositories to make aggregate data on open positions and trading volumes available to the public;
- Requiring clearinghouses and trade repositories to make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC and other regulators;
- Requiring centralized clearing of standardized swaps;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and

- Requiring the timely reporting of trades and prompt dissemination of prices and other trade information;

Promote Market Integrity. It would promote market integrity by:

- Providing CFTC with clear, unimpeded authority to impose reporting requirements and to prevent fraud, manipulation and other types of market abuses;
- Providing CFTC with authority to set position limits, including aggregate position limits;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring business conduct standards for dealers.

Protect Against Improper Marketing Practices. It would ensure protection of the public from improper marketing practices by:

- Business conduct standards applied to derivatives dealers regardless of the type of instrument involved; and
- Amending the limitations on participating in the OTC derivatives market in current law to tighten them or to impose additional disclosure requirements, or standards of care (e.g. suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

Beyond the need to bring broad reform to OTC derivatives dealers and markets, I would like to raise with the Committee two other important matters.

Retail fraud. In the 2008 Farm Bill the Congress clarified the CFTC's jurisdiction over fraud in retail foreign currency transactions. Since the passage of the Farm Bill, unscrupulous firms have been offering the same type of fraudulent "rolling spot" commodity contracts that were prohibited in the Farm Bill, but in other commodities that were not covered by the bill. Since the enactment of the Farm Bill, the CFTC has received more than 50 complaints from the public relating to potential fraud from such contracts. The regulatory reform package should include a provision to expand the CFTC's jurisdiction over this type of retail fraud to all types of commodities.

Foreign Boards of Trade. As part of regulatory reform legislation, the Congress should also provide the CFTC with clear statutory authority to ensure that traders that are trading on a foreign board of trade through trading terminals in the U.S. comply with the same U.S. position limits and reporting requirements when trading a foreign contract that settles against any price of a contract traded on a U.S. exchange. Foreign boards of trade should not be permitted to operate in the U.S. unless they impose and enforce comparable position limits on these contracts and provide comparable trading data to the CFTC as is regularly provided by the U.S. exchanges. This is often referred to as "closing the London loophole." Traders in the U.S. should not be able to avoid U.S. position limits or reporting requirements by moving their trades onto a foreign exchange.

Conclusion

The need for reform of our financial system today has many similarities to the situation facing the country in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress "the enactment of legislation providing for the regulation by the Federal Government of the

operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.” The Congress swiftly responded to the clear need for reform by enacting the Securities Exchange Act of 1934. Two years later it passed the Commodity Exchange Act of 1936.

It is clear that we need the same type of comprehensive regulatory reform today. Today’s regulatory reform package should cover all types of OTC derivatives dealers and markets. It should provide the CFTC and other federal agencies with full authority regarding OTC derivatives to lower risk; promote transparency, efficiency, and market integrity and to protect the American public.

Today’s complex financial markets are global and irreversibly interlinked. We must work with our partners in regulating markets around the world to promote consistent rigor in enforcing standards that we demand of our markets to prevent regulatory arbitrage.

These policies are consistent with what I laid out to this committee in February and the Administration’s objectives. I look forward to working with this Committee, and others in Congress, to accomplish these goals.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I look forward to answering any questions.

Testimony of Mark Lenczowski
JPMorgan Chase & Co. (JPMC)
Senate Agriculture Committee
June 4, 2009

Chairman Harkin, Ranking Member Chambliss, and Members of the Committee, my name is Mark Lenczowski, and I am a Managing Director and Assistant General Counsel at JPMorgan Chase & Co. I provide legal advice to our over-the-counter (OTC) derivatives businesses, primarily with respect to interest rate, foreign exchange and commodity transactions. Thank you for inviting me to testify at today's hearing.

Benefits of OTC Derivatives to Our Economy

For the past 30 years, American companies have used OTC derivatives to manage interest rate, currency, and commodity risk. Beginning in the early 1970s, global economic forces began to affect American companies, regardless of business type or scope of operations, and two key events are especially noteworthy:

- (1) the United States dropped the gold standard in 1971, which led to floating exchange rates;
- (2) severe oil price shocks led to increased volatility in commodity prices and interest rates.

These events presented complex financial risk management challenges that, left unmanaged, would have negatively affected many companies' financial performance and possibly even their viability. In response to marketplace demand, financial products, such as futures contracts and OTC derivatives, were developed to provide companies with tailored and flexible risk management tools.

Since their inception, OTC derivatives have been used by companies that are exposed to risks in the course of their day-to-day operations that they are unable to manage themselves. As a result, interest rate, currency and commodities derivatives became important and commonplace tools for these companies in 1980s and 1990s. Credit derivatives were developed over the past 10-12 years and -- when used responsibly -- have served a similar, useful role in managing credit risk. Since then, OTC derivatives have become a vital part of our economy. According to the most recent data, 92% of the largest American companies and over 50% of mid-sized companies use OTC products to hedge risk.

The role of entities like J.P. Morgan in the OTC derivatives market is to act as financial intermediaries. In much the same way financial institutions act as a go-between with investors seeking returns and borrowers seeking capital in the OTC derivatives market, we work with companies and other end-users looking to manage their risk with entities looking to take on those risks.

In this role, we work with many American and global companies and help them manage their risks. Recently, many of our clients have expressed great concern on the affects of the proposed legislative and regulatory changes on their businesses. Clients such as BP, Chesapeake, Constellation and Cargill are very worried about the unintended consequences of these policy proposals, particularly at a time when our economy remains fragile. In our view,

the effect of forcing such companies to face an exchange or a clearinghouse would limit their ability to manage the risks they incur in operating their business and have negative financial consequences for them via increased collateral and margin posting. These unintended repercussions have the potential to harm an economic recovery. We welcome the opportunity to discuss these issues today.

Let me first discuss in detail some of the benefits of OTC derivatives.

{1} Tailored Risk Management

Companies today demand customized solutions for risk management, and the OTC market provides them.

Interest rates

As an example, a typical OTC derivative transaction might involve a company that is borrowing in the loan market at a floating interest rate. This product is similar to a variable rate home mortgage. To protect themselves against the risk that interest rate will rise, the company will enter into an interest rate swap. These swaps generally enable the company to pay an amount tied to a fixed interest rate, and the financial institution will pay an amount tied to the floating rate of the loan. Similar to the homeowner in a variable rate mortgage, if rates rise steeply, they have some protection. Every aspect of the swap can be tailored to the company's needs to ensure that the company is able to match its risks exactly. It is that customization that makes OTC derivatives so useful to companies.

Currencies and commodities

OTC transactions are used in a similar manner by a wide variety of companies seeking to manage volatile commodity prices and foreign exchange fluctuations.

For example, a company may be importing raw materials into the United States to manufacture a product that is sold all around the world – such as aircraft. That American company will want to protect themselves and their shareholders from bearing undue risk if the price of the dollar fluctuates against the currencies it uses to buy raw materials. With no change to its business model, it could find itself in a situation where the price to produce the planes is higher than the profit it makes from selling those planes, simply due to exchange fluctuations outside its control. It could also find itself exposed to changing prices in commodity raw materials, such as steel or fuel. Any responsible company would act to prevent putting itself in this kind of jeopardy and its employees, clients and shareholders at great risk.

In this example, the aircraft company will purchase a currency derivative in the OTC foreign exchange market that allows it to lock in the exchange rate for each of the currencies that it is exposed to. The company would also likely purchase a commodity derivative that will lock in the price of the raw materials. These transactions allow the aircraft company to focus on its core competency -- building planes -- rather than fearing foreign exchange or commodity price risk.

It is important to note that although interest rate and currency derivatives currently are offered

on US exchanges, few corporations use these exchange-traded contracts for two main reasons:

- Exchange-traded products are, by necessity, highly standardized and not customized. As a result, companies are unable to match their unique risks to the products that are offered on exchanges; and
- Exchange/clearinghouse collateral requirements are onerous. Clearinghouses (including those that support exchanges) require that participants pledge only liquid collateral, such as cash or short-term government securities, to support their positions in the market without regard to the credit quality of the company. However, companies need their most liquid assets for their working capital and investment purposes. Requiring a company to post cash as collateral means taking that cash out of the company's core business, which hurts the company and its employees.

(2) Collateral

In addition to customization, the other main benefit of OTC derivatives is flexibility with respect to its ability to provide collateral to support its derivative transaction. In the interest rate swap example, the financial institution may ask the company to provide credit support to mitigate the credit risk that it faces in entering into this transaction. Most often, that credit support comes in the same form as the collateral provided for the loan agreement. Thus, if the loan agreement is secured by property, fixtures and/or receivables, that same collateral would also be used to secure the interest rate swap. As a result, the company does not have to incur additional costs in obtaining and administering credit support for the interest rate swap.

The flexibility of the credit support arrangement provided by OTC products is best highlighted by contrasting it to the posting requirements the company would have faced had it executed its interest rate swap transaction on an exchange. The CME Group and its predecessor institutions pioneered risk management products and currently trade a wide variety of interest rate futures and options contracts, including interest rate swap futures, and all companies are free to enter into these contracts. (In fact, JPMC is one of the biggest users of these exchange-traded risk management contracts). However, the exchange requires a high degree of standardization in the contracts it trades, and requires that transacting entities post cash or cash-equivalent collateral to support their trades. In addition, collateral calls may be made up to twice daily, to account for market fluctuations. This requirement of readily marketable collateral is necessary to ensure the clearinghouse is protected from risk; the clearinghouse or clearing member must instantaneously apply that collateral in the event of a participant default.

A clearinghouse is a very highly collateralized central counterparty that becomes the buyer to every seller and the seller to every buyer. In order for the clearinghouse to perform its credit risk mitigating role in the financial system, it is essential for the clearinghouse to be able to calculate accurately how much collateral it needs from a participant to secure the transactions on which it faces that participant. This can only be done for derivatives that are sufficiently standardized and liquid to enable the clearinghouse to obtain prices quickly so that it can calculate how much collateral is needed. This cannot be done with illiquid or non-standard transactions.

Thus, in the example above, if the company had executed its hedge on the exchange, it would have had to post cash or readily marketable collateral upfront and up to twice daily thereafter.

By entering into the transaction in the OTC market, the company is able to use the same collateral that it already posted to secure its loan, with no additional liquidity demands or administrative burdens. This collateral is high quality, being the basis for the extension of credit in the loan agreement, but posting it does not affect the company's operations or liquidity. This flexibility to use various forms of credit support significantly benefits companies.

(3) Basis Risk

Another benefit to companies is that unlike exchange-traded derivatives, OTC derivatives match very closely the actual risks that companies need to manage. Without this fit, companies are exposed to so-called "basis risk" -- that is, the difference between the risk that is incurred and the benefit of the hedge. To the extent that there is misalignment of the risk and the hedge, companies will bear the risk of the difference, which could be significant, depending upon the volatility of prices and the level of standardization of the hedge. In fact, the precision of the "fit" determines whether companies qualify for hedge accounting, delineated in FAS 133, which has been developed to address the accounting for hedging transactions. Because of the tailored solutions available through the OTC market, using OTC derivatives is the easiest and most effective way for companies to achieve hedge accounting. Without hedge accounting, companies will see significant volatility in their financial reporting, obscuring the true value of their business.

While we believe that exchanges play an invaluable role, not all entities can or want to trade on exchange. Currently, end-users have the choice of entering into their hedging transactions on an exchange or in the OTC market. For most end-users, OTC derivatives are critical to their risk management, and risk management is critical to their operations in volatile times. We believe that end-users should continue to be allowed to have the choice to use these products.

Problems with use of OTC Derivatives

The discussion of the benefits of OTC derivatives is not to deny that there have been problems with their use, and it is essential that policymakers examine the causes of the financial crisis to ensure it is never repeated. While JPMC does not believe that OTC derivatives were the cause of the financial crisis, it is clear that AIG's near-failure and the consequent investment by US taxpayers involved a subset of credit default swaps as well as poor risk management by its counterparties. In addition, the regulatory framework did not subject AIG to a thorough, comprehensive review--the kind of regulatory oversight to which a national or state bank's derivatives activities are currently subject.

Despite the failures at AIG, it is critical to point out that the markets in these products have continued to be available for end-users, and defaults have been processed as the market infrastructure envisioned.¹ Nonetheless, we believe there is an urgent need for reform to

¹ For example, Lehman Brothers had a portfolio of OTC interest rate derivatives transactions that had an aggregate notional value of \$9 trillion and that was cleared through LCH Clearnet, a clearinghouse that clears the majority of OTC interest rate swap transactions entered into between financial intermediaries. Upon Lehman's bankruptcy, the clearinghouse auctioned the portfolio, pursuant to its rules, and eliminated the market risk without having to tap its guaranty fund. In addition, Lehman's bankruptcy triggered settlement of credit default swaps that referenced Lehman. It is estimated that there was up to \$400 billion of such transactions outstanding, in gross notional terms, but at settlement, after netting all positions, the

address systemic risks that have been revealed by the financial crisis and that reform should encompass OTC derivatives.

Proposals

JPMC believes it is imperative that the root causes of the financial crisis be addressed and that regulatory reform address systemic risk while preserving the benefits of OTC derivatives for end-users. To that end, we propose the following:

- **Financial regulation should be considered on the basis of function not form.** That is, the appropriate regulatory framework should be determined on the basis of what an entity does rather than what legal entity form it takes.
- **A systemic risk regulator should oversee all systemically significant financial institutions and activities.** We believe it is necessary to establish a systemic risk regulator charged with the responsibility to oversee all systemically significant financial institutions and that this regulator should have the capability to impose capital requirements on these institutions, to oversee their transactions with each other and with their customers, and to impose conditions on those transactions, such as collateral requirements.
- **All standardized OTC derivatives transactions between systemically significant financial institutions or professional intermediaries should be cleared through a regulated clearinghouse.** The standardization requirement is necessary because, as discussed above, only transactions with a degree of standardization are capable of being risk-managed by the clearinghouse and thus be eligible for clearing.
- **Enhanced reporting requirements should apply to all OTC derivatives transactions.** For cleared transactions, the clearinghouse would have data on aggregate trading volumes and positions as well as specific counterparty information. Non-cleared transactions should be reported to a trade repository on a frequent basis, and the repository should publish aggregate market data. The systemic risk regulator as well as market regulators such as the CFTC or SEC should have access to the trade-specific data, and regulators should also have the ability to request more detailed information as required.

Industry Actions

In addition to these proposals for federal legislative action, we believe that financial intermediaries can and should act in concert with regulators to begin to provide a more effective framework for the clearing of OTC derivatives products. Clearing of clearing-eligible transactions provides additional stability to the American financial system. By way of example, in the interest rate swap market, we clear 70% of new transactions. A significant portion of credit default swaps (CDS) have become standardized over time, and we have worked since

total payments owed were between \$6 and \$8 billion dollars. The calculation and payment process occurred in an orderly manner with no reported problems.

2005 with other financial institutions and the Federal Reserve to establish a central counterparty (CCP) to clear standardized CDS. The ICE Trust clearinghouse launched on March 9th and has begun clearing CDS. We anticipate that a significant majority of dealer-to-dealer CDS trading volume will ultimately be cleared as products are migrated to the clearinghouse. In the commodity derivatives market, we clear a significant amount of our inter-dealer OTC derivatives as well.

CDS Clearing

As the ICE Trust clears more clearing eligible CDS contracts, we anticipate that in the near future the large majority of dealer to dealer clearing eligible CDS contracts will be cleared as a matter of routine. Clearing is a highly transparent process, and anyone with access to the internet can view data free of charge. The data relates to daily volume traded, as well as the price used by the clearinghouse for calculating how much collateral the clearinghouse will require from each dealer. The links to the websites showing that data:

<https://www.theice.com/marketdata/reportcenter/reports.htm?reportId=98>
<http://www.markit.com/information/products/cds/cds-page.html>

Interest Rates Clearing

Currently this market clears using the London-based LCH SwapClear service. For outstanding trades as at the close of 2008, SwapClear clears approximately \$160 trillion in notional, which equates to roughly 50% of inter-dealer swap trades globally.

Commodities Clearing

During the three month period ending in February 2009, OTC commodity derivatives dealers cleared on average approximately 40% of their OTC energy derivatives transactions and 35% of other commodity derivatives (excluding metals and agricultural products). We anticipate these percentages will increase over time.

FX Clearing

Clearing has not been an industry practice because FX/currency OTC contracts tend to have shorter maturities, which generally decreases counterparty risk, and counterparty risk is the primary driver for the development of clearinghouses. However, discussions on this have begun among dealers and regulators.

JPMC is committed to working with Congress, regulators and other industry participants to ensure that an appropriate regulatory framework for derivatives is implemented. I appreciate the opportunity to testify and look forward to your questions.

Testimony of

**Michael W. Masters
Managing Member / Portfolio Manager
Masters Capital Management, LLC**

before the

**Committee on Agriculture, Nutrition and Forestry
United States Senate**

June 4, 2009

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Good morning, Chairman Harkin, Ranking Member Chambliss and Members of this Committee. I welcome the opportunity to appear before you today and testify on the very important topic of derivatives regulation.

EXECUTIVE SUMMARY

The derivatives markets present Congress, financial regulators and the Obama Administration with two very critical and very distinct problems. The first problem involves **systemic risk**, the risk of the world's financial system crashing, as we nearly experienced in the last four months of 2008. The second problem involves **excessive speculation**, whereby price bubbles occur in consumable commodity derivatives markets, pumping up the prices that Americans pay to feed their families, fuel their cars and heat their homes. While excessive speculation is not new, it has given rise to the very serious issue of **passive "investment"** in derivatives on consumable commodities.

The **systemic risk** problem can be virtually eliminated by mandatory exchange clearing with novation and daily margin posting. Nearly all over-the-counter (OTC) derivatives can clear through a Designated Clearing Organization (DCO). My testimony will detail exactly what elements of clearing are required to eliminate the risk to the financial system as a whole.

The **excessive speculation** problem can be eliminated by imposing aggregate speculative position limits. These limits must cover all trading venues and apply at the control entity level. Fifteen years ago almost all derivatives trading for consumable commodities such as crude oil, copper and corn took place on fully regulated futures exchanges where each commodity had a single liquid contract with strict speculative position limits in place. Today, derivatives trading on consumable commodities takes place across multiple venues. In order to effectively impose aggregate speculative position limits, all of those venues must be regulated equally, which will require closing all of the loopholes that have been opened up over the last 15 years.

To address the problem of **passive "investment"** in derivatives on consumable commodities, policymakers must first understand the critical distinction between financial derivatives and derivatives on consumable commodities. Once that is understood, it will become clear that the solution to the passive investment problem is the severe restriction of such damaging buy-and-hold "investment" strategies.

CURRENT BACKDROP

Near Collapse of the World Financial System

The world financial system, with Wall Street at its core, teetered on the brink of collapse during the last four months of 2008. This near meltdown had a catastrophic effect on our nation's economy, causing the loss of trillions of dollars in retirement savings and millions of American jobs, and requiring trillions of dollars in taxpayer money to flow to Wall Street to avoid a complete collapse.

The sums of money that have flowed to Wall Street during this crisis are almost beyond comprehension. The United States has doled out more money to fix Wall Street than we spent to fight all the wars in our nation's history, including World War I, World War II and the War in Iraq.

Many, including President Obama, have referred to this as the greatest economic crisis since the Great Depression. Congress owes it to the American people to understand and eliminate the existing weaknesses in our financial system in order to ensure that Wall Street never inflicts this kind of pain upon Main Street again.

The 2008 Bubble in Food and Energy Prices

The rapid deterioration of credit markets, which pushed our financial system to the brink, was greatly exacerbated by the meteoric and unjustified rise in food and energy prices during 2008. I testified extensively last year on the role of speculation in driving up the prices of life's basic necessities and the damaging effects that this had on our nation's economy. Time does not permit me to share all those facts and figures this morning, but I would refer you to my previous testimonies and the three reports that I have co-authored on the subject.¹

At this time, however, I would like to share a few key observations related specifically to the price of oil. According to the National Bureau of Economic

¹ May 20, 2008 – Testimony before Senate Homeland Security Committee
 June 23, 2008 – Testimony before House Energy Subcommittee
 June 24, 2008 – Testimony before Senate Homeland Security Committee
 July 31, 2008 – Report entitled "The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices"
 September 10, 2008 – Report entitled "The Accidental Hunt Brothers – Act 2: Index Speculators Have Been a Major Cause of the Recent Drop in Oil Prices"
 September 16, 2008 - Testimony before Senate Energy Subcommittee
 February 4, 2009 – Report entitled "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens"
 February 4, 2009 – Testimony before House Agriculture Committee
 All three reports can be downloaded from www.accidentalthuntbrothers.com.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Research (NBER), the United States entered an economic recession in December of 2007.² So U.S. economic output was dropping during the first six months of 2008. During that time, the worldwide supply of oil was increasing and the worldwide demand for oil was decreasing.³ With the world's largest oil consumer in an economic recession and with supply rising and demand falling, the price of oil should have been falling. Instead, oil defied the economic recession and defied the laws of supply and demand and rose an astronomical \$50 per barrel from the mid-\$90s to a peak of \$147 per barrel in just six months.

Beginning in mid-July, the oil bubble popped and the price of oil tumbled over \$110 per barrel from the mid-\$140s to a low of \$33 per barrel in less than six months. Never before in history has the price of oil fallen so far or so fast. Tim Evans, who is an energy analyst with Citigroup, summed it up the best, saying, "This is a market that is basically returning to the price level of a year ago, which it arguably should never have left, . . . We pumped up a big bubble, expanded it to an impressive dimension, and now it is popped and we have bubble gum in our hair."⁴

As I have documented extensively in my reports and previous testimonies, I believe the major factor behind this bubble in oil prices was the flow of speculative money into and out of the oil futures market.

The Potential 2009 Bubble in Oil Prices

While the threat of Congressional action in the summer of 2008 might have been a major catalyst for popping last year's speculative bubble in oil, nothing was actually done by Congress to put an end to the problem of excessive speculation. As a result, there is nothing to prevent another bubble in oil prices in 2009. In fact, signs of another possible bubble are already beginning to appear.

According to the Energy Information Administration (EIA), the available supply of crude oil in the United States is at a 20-year high, while the demand for crude oil is at a 10-year low.⁵ The International Energy Agency (IEA) sees a similarly bleak supply and demand outlook for the world as a whole.⁶ And yet, despite this glut of unwanted oil, the price has risen an amazing 85% per barrel from the mid-\$30s to mid-\$60s. In fact, oil prices increased more in the month of May than in

² "Determination of the December 2007 Peak in Economic Activity," Business Cycle Dating Committee, National Bureau of Economic Research, November 11, 2008. <http://www.nber.org/cycles/dec2008.html>

³ "World Oil Balance 2004-2008," Energy Information Association - United States Department of Energy, April 13, 2009. <http://www.eia.doe.gov/emeu/ipsr/t21.xls>

⁴ "The Official Demise Of The Oil Bubble," David Gaffen, Wall Street Journal, October 10, 2008.

⁵ "Are Wall Street speculators driving up gasoline prices?" Kevin G. Hall, McClatchy Newspapers, May 20, 2009.

⁶ "Investor Hopes for Rising Oil Demand Aren't Borne Out by Reality," Ben Casselman, Wall Street Journal, June 1, 2009.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

any other month for the last 10 years. How is this possible, given our current economic woes and the tremendously negative supply and demand picture?

There has been a chorus of voices from market participants, economists and even OPEC, squarely pinning the blame on speculators for unjustifiably driving oil prices higher.⁷ Today, the price of oil is determined not primarily by the familiar laws of supply and demand, but largely by the trading desks of large Wall Street institutions.

If Congress allows this to continue, then once again oil prices threaten to throw our economy back into a double-dip recession, squashing all of the Obama Administration's attempts to revive our economy. Your constituents are flat on their backs financially and will not tolerate gasoline prices rising to \$3 or \$4 per gallon. High energy prices pose a threat to the things this Congress is trying to achieve - climate change, health care, et cetera - because all of those initiatives will be deemed too expensive.

Something must be done. Congress must act now before the U.S. economy is once again brought to its knees.

PROBLEM ONE: SYSTEMIC RISK

There were many factors that led to the rapid deterioration in credit markets and large losses on Wall Street during 2008. There was, however, one single factor that threatened to bring down the financial system as a whole. That was the interlocking web of over-the-counter (OTC) derivatives exposures amongst the biggest Wall Street swaps dealers. Many financial institutions might have gone bankrupt or suffered severe losses, but the system as a whole would not have been imperiled were it not for these completely unregulated dark markets.

OTC derivatives are bilateral contracts entered into between swaps dealers and their customers and between swaps dealers and each other. These contracts are agreements to pay one another certain amounts of money based on the direction of some price series that the contract references. OTC derivatives can encompass interest rates, credit spreads, equities, foreign exchange, commodities and even things as intangible as the weather.

Embedded in every OTC derivative is a credit exposure between the two counterparties based on the likelihood that each counterparty will be able to pay if their bets turn sour. This credit component is a major concern, because often little or no margin collateral is required to be posted to enter into these transactions. For this reason, the major money center banks with the best credit

⁷ "OPEC Calls for Curbing Oil Speculation, Blames Funds (Update2)," Maher Chmaytelli, Bloomberg, January 28, 2009.

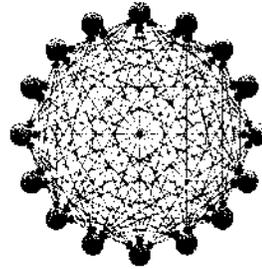
Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

ratings are also the largest swaps dealers, because they are the most sought-after counterparties.

The larger a swap dealer is, the more exposures they have to various counterparties and the larger the size of those individual exposures. Since there is a great deal of trading amongst swaps dealers, there is an interlocking web of very large exposures amongst the 20–30 largest swaps dealers.

At the peak in 2008 the notional amount of OTC derivatives contracts outstanding totaled over \$684 trillion.⁸ These positions represented an extreme amount of leverage, as very little margin collateral backed up these huge bets.

Graphical Illustration of
Interlocking Web of Exposures



When Lehman Brothers went bankrupt, many of the major swaps dealers, as well as Lehman Brothers' swaps customers, immediately lost large sums of money that they were owed. At that point, every swaps dealer radically reevaluated the creditworthiness of their counterparties and questioned who might be the next to fail.

While swaps dealers knew the extent of their own exposures, they did not know the extent of anyone else's exposure. They did not know if one of their counterparties lost so much money to Lehman Brothers that they, too, might be forced to file bankruptcy. Not knowing this information, their self-preservation instinct forced them to reduce all their counterparty exposures as much as possible, since they did not know who was viable and who was bankrupt. This phenomenon was multiplied as all of the swaps dealers' customers took the same actions to limit their exposures. The net effect was to force the OTC derivatives market to come to a grinding halt.

This unregulated shadow banking system, as it has been called, was effectively destroyed, which threatened to destroy the regulated financial system with it. At this point, regulators were forced to pump trillions of dollars into the shadow banking system to allow OTC derivatives dealers to make each other whole on their bets. This was necessary to prevent a domino effect of dealer collapses that would have destroyed the world's financial system.

⁸ Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008.
<http://www.bis.org/statistics/derstats.htm>.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The most notorious of these dealers has been AIG. AIG is not even a bank, but the Federal Reserve was forced to bail them out because if the Fed had allowed AIG to go under, they would have dragged the whole financial system with them.

SOLUTION: MANDATORY EXCHANGE CLEARING

The risk of a financial system collapse must be eliminated, not regulated.

The U.S. does not need a Systemic Risk Regulator. We need regulation that eliminates the risk to the system. A fundamental premise of finance is that return follows risk. Wall Street swaps dealers should not be allowed to earn an outsized return by putting our financial system at risk.

The problems inherent in the shadow financial system were two-fold:

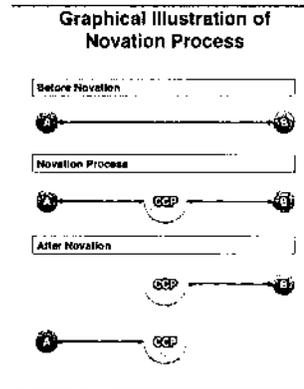
(1) The interlocking web of very large exposures between the major swaps dealers created the potential for a domino effect, wherein the failure of one dealer could lead to the failure of all dealers.

(2) Losses did not have to be very high in order to force the first domino to fall, due to the extreme leverage that characterized those positions. This leverage was the result of requiring little or no margin collateral to be posted to insure those bets.

Everyone agrees that clearing needs to take place in order to increase the transparency of OTC derivatives markets. But not all clearing is created equal, and Congress must mandate that all OTC derivatives clear through a Designated Clearing Organization (DCO).

This clearing process must include two important provisions in order to counteract the two inherent problems in the shadow financial system. First, clearing must involve novation, wherein the DCO becomes the Central Counterparty (CCP) to both sides of the trade. And second, clearing must involve daily margin posting wherein the DCO/CCP collects daily margin variation payments from those dealers whose bets are going against them.

As an example, if Bank A enters into an interest rate swap with Bank B, then once that swap agreement clears, with novation, through the CCP, then the CCP becomes the counterparty to both

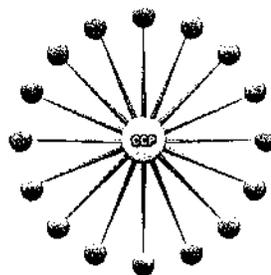


Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Bank A and Bank B. The result is that Bank A and Bank B are no longer counterparties to each other.

By insisting upon novation, the interlocking web of exposures amongst swaps dealers is eliminated, because every dealer's exposure is to the DCO/CCP. Another swaps dealer can go bankrupt and it will not affect any of the other dealers because they only have one counterparty – the Central Counterparty.

Graphical Illustration of Swaps Market with Central Counterparty (CCP)



To protect itself, the CCP will require that margin collateral be posted with the initial trade. The CCP will further require that additional margin collateral be posted on a daily basis as market prices fluctuate and those bets result in profits or losses.

As an example, on a \$100 million interest rate swap, each counterparty might have to post \$8 million (the actual amount will be determined by the riskiness of the swaps contract). Then, if at the end of any day, one counterparty is approaching an \$8 million loss on their position, the Central Counterparty will require them to post another \$8 million in order to continually ensure that they have the money to cover their bets.

If this system had been in place last year, then AIG would never have been forced to the brink of bankruptcy. AIG had been putting aside very little margin with which to pay its bets. When AIG's credit rating was downgraded and it was forced to post margin, it did not have the cash to do it. This liquidity squeeze could have been completely avoided if AIG's OTC derivatives trades had cleared with novation through a DCO that required them to post daily margin.

Wall Street Will Oppose These Steps

Recently, the New York Times and the Wall Street Journal have featured articles about what Wall Street is trying to do right now to block efforts at derivatives legislation which, if passed, will cut into their profitable swaps dealing business.⁹ There are three reasons why Wall Street does not like the idea of mandatory exchange clearing of all OTC derivatives.

First, though they express a desire for transparency and got burned last year by the lack of transparency, they know that with greater the transparency comes

⁹ "In Crisis, Banks Dig In for Fight Against Rules," Gretchen Morgenson and Don Van Natta, New York Times, May 31, 2009.

"Banks Seek Role in Bid to Overhaul Derivatives," Serena Ng, Wall Street Journal, May 29, 2009

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

narrower bid-ask spreads. As long as they can keep their clients in the dark as to what the true prices are for swaps, the longer they can charge their clients a substantial premium for entering and exiting trades.

Second, once all OTC derivatives are mandated to clear with novation (so that the DCO also becomes the CCP), their credit ratings will no longer be a competitive advantage. They will lose oligopoly pricing power because any two counterparties can trade, regardless of their respective credit ratings, since the CCP becomes the ultimate counterparty to all trades.

Third, they will lose access to unlimited leverage, and leverage ratios will have to come down from 30x or more to something closer to 12x. This means additional financing costs for each trade, which will cut into profitability.

Appropriate Standards for What Must Clear

Wall Street will seek to block mandatory exchange clearing by arguing that swaps are highly customized and that the vast majority of swaps cannot clear. While swaps might have certain elements of customization, they are, by their very nature, more standardized than Wall Street wants to admit.

Almost every OTC derivatives agreement references some published third party pricing service. As an example, for interest rate swaps it is often the London Interbank Offered Rate published by the British Bankers Association. This makes a swap based on LIBOR largely fungible with another swap that references LIBOR. After all, if these swaps were all unique then they could never be traded back and forth between swaps dealers.

For that reason, the standard that regulators should adopt for determining whether or not OTC derivatives should clear is not one of standardization versus customization but rather one of clearable versus non-clearable.

This standard was presented very clearly and forcefully by Chairman Gensler of the Commodities Futures Trading Commission (CFTC) during his confirmation hearing in front of this committee.¹⁰ He said repeatedly that if an OTC derivative can clear, then it should clear. This standard was reiterated by Treasury Secretary Geithner in his letter to Congress outlining the Administration's plans for derivatives regulation, where he said "if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared."¹¹

¹⁰ Senate Agriculture Hearing, February 25, 2009

¹¹ Letter to Senate Majority Leader Harry Reid from Treasury Secretary Timothy Geithner, May 13, 2009. www.financialstability.gov/docs/OTCletter.pdf

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Derivatives Clearing Organizations regulated by the CFTC have a more than 140-year history of serving as a Central Counterparty. They know which OTC derivatives are standardized and clearable compared with those that are customized and unclearable. As the CCP, they will not clear anything that they cannot value or assess the risk upon. DCOs can be trusted to not clear anything that is customized to the point that it should not clear. Congress will find that the vast majority of OTC derivatives can clear with novation through DCOs.

For the highly customized OTC derivatives that cannot clear, there is a very strong question as to their utility and their social value. Why would someone need to enter into a swap agreement that is so esoteric and inscrutable that a DCO is not willing to touch it? Given the extreme risk associated with such exotic (I would even say toxic) derivatives, banking regulators should require that those derivatives carry capital charges of 50% or more. Then, if a bank enters into a \$100 million exotic unclearable swap, they would be required to set aside \$50 million in capital to cover any potential losses arising from that bet.

Wall Street will try to shift the debate to standardized vs. customized in order to avoid clearing. Congress has the responsibility to make clearable vs. non-clearable the right standard.

CRITICAL DISTINCTION: FINANCIAL DERIVATIVES VERSUS DERIVATIVES ON CONSUMABLE COMMODITIES

Financial instruments are things like stocks and bonds that investors hold in order to receive dividends, interest, cash flows, etc. Because of these associated cash flows these instruments have intrinsic value as investments. Financial instruments are designed to be held (often for the long term) by investors in a portfolio. Stocks, bonds and other financial instruments are issued in the capital markets by corporations for the purposes of funding daily operations and making large project investments for future growth.

Commodities are things like crude oil, copper and corn that are produced from the earth or produced from things that are produced from the earth. The value that human beings derive from commodities comes from their ability to be consumed. Commodities are essential to our economy (like energy) or essential to life itself (like food). Modern society cannot survive without the ability to consume commodities.

Derivatives are financial contracts that derive their value from an underlying asset. Derivatives exist on financial instruments as well as on consumable commodities. The U.S. derivatives markets on consumable commodities date back to 1865; derivatives markets on financial instruments were established over

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

100 years later when the first foreign currency contracts began trading in the early 1970s.

Financial derivatives quickly came to dwarf derivatives on consumable commodities. In fact, in June of 2008 when there were \$684 trillion in outstanding OTC derivatives contracts, only \$12.6 trillion was on consumable commodities (less than 2%).¹² With this proliferation, market participants and regulators have lost sight of the critical differences between financial derivatives and derivatives on consumable commodities.

In the financial derivatives markets, every participant is a speculator. Therefore, there is no such thing as "excessive speculation" in financial derivatives. Investors can use financial derivatives to hedge price risk related to underlying financial instruments in their portfolios. An example would be an equity mutual fund manager who might sell S&P 500 futures to reduce his exposure to market risk. Investors can also use financial derivatives to take on price risk. That same equity mutual fund manager might buy S&P 500 futures when he receives an influx of investor cash to maintain market exposure while he is working into the individual stock positions.

In the derivatives market for consumable commodities, in contrast, there are two completely distinct classes of market participants: bona fide hedgers and speculators. Bona fide hedgers are the actual producers and consumers of the physical commodities. They come to the commodities derivatives markets with inherent price risk from their underlying businesses, which they seek to reduce or eliminate. This is achieved when a producer who needs to sell enters into a contract with a consumer who needs to buy. This way both the producer and consumer agree to a future price and thereby eliminate their price risk.

Unlike bona fide physical hedgers, speculators in the derivatives market for consumable commodities have no business in the underlying commodity and therefore no price risk to hedge. If they do not want to assume price risk then their choice is simple, they simply do not transact in these markets. Speculators can always avoid price risk by simply not transacting.

Bona fide physical hedgers do not have that luxury. They provide a vital service to the worldwide economy by producing the essential commodities that the world needs to consume to survive.

In 1936, recognizing that the derivatives market for consumable commodities was created solely for the benefit of bona fide physical hedgers, Congress enacted the Commodity Exchange Act. This legislation allowed for regulators to

¹² Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008. <http://www.bis.org/statistics/derstats.htm>. Please note these figures do not include gold or other precious metals.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

police the commodities futures markets for fraud, manipulation and excessive speculation.

Congress might have banned speculators from the commodities futures markets completely, but it was believed that a limited amount of speculation in the markets was necessary. Speculators were needed on the floor of the commodities futures exchanges so that when sell orders were transmitted via telegraph to the exchange floor, if they did not match up immediately with a comparable buy order (or vice versa) then the crowd of locals could fill those orders, buying and selling and balancing out the needs of producers and consumers. The locals in the pits acted essentially like middlemen or market-makers, similar to the way specialists operated on the New York Stock Exchange.

Perhaps I impute too much wisdom and forethought to Congress at the time but it seems like they were fully aware that buy orders and sell orders are what determine prices and that buying and selling - no matter who is doing it - will determine prices. For that reason, Congress put limits on speculators to ensure that bona fide physical hedgers were dominant in the price discovery process.

It was (and still is) essential that bona fide physical hedgers remain the dominant force in the commodities futures markets for four reasons:

1. **The commodities futures markets exist for the benefit of bona fide physical hedgers**, to provide a way to reduce risk and ensure the continued production of the essential commodities that our economy and citizens rely on every day for our existence.
2. **Bona fide physical hedgers trade to reduce risk, not to take on more risk.** Their primary business is producing and consuming, so their derivatives trading decisions are based on input and output, not emotion.
3. **Physical commodity producers and consumers trade based upon the actual physical supply and demand conditions that they are experiencing in their underlying businesses.** A farmer does not sell more wheat contracts than he actually intends to produce. A miller does not buy more wheat contracts than he actually intends to turn into flour.
4. **Speculative markets are susceptible to price bubbles.** Speculators throughout history have been famous for manias, panics and crashes. As an example, every significant capital market has had a major price bubble in the last ten years (emerging markets bubble, internet/tech bubble, housing bubble, etc). It is common for speculators, when they see prices rising, to pour money into a market, which causes the price to rise even more and attract even more speculators. This self-reinforcing cycle is what leads to price bubbles in excessively speculative markets.

PROBLEM TWO: EXCESSIVE SPECULATION

Excessive speculation is a condition of the derivatives markets for consumable commodities where speculators become more dominant in the marketplace than physical commodity producers and consumers. When excessive speculation is accompanied by speculative euphoria, completely unnatural bubbles occur in the prices for consumable commodities.

I label price bubbles in consumable commodities as unnatural because commodity prices naturally seek an equilibrium point equal to the marginal cost of production. As an example, if wheat prices fall below a level where the wheat farmer can cover his costs, then he will not plant any more wheat, which will result in reduced production and reduced supply, which will lead to higher prices in the future. If wheat prices rise to a level where the wheat farmer is making a dramatic profit above his costs, then he will plant as much wheat as he possibly can, which will increase production and increase supply and lead to lower prices in the future.

The decisions of physical commodity consumers also contribute to the stabilization of prices toward long-term equilibrium. When prices rise they demand less, which leads to excess supply and a falling price. When prices fall then they consume more, which leads to reduced supply and a rising price. So under normal conditions, commodities naturally stabilize around a long-term equilibrium level.

When speculators become dominant in the market for derivatives on consumable commodities, the supply- and demand-based trading of physical commodity producers and consumers takes a back seat to the high stakes trading of speculators as they attempt to out-trade each other to maximize their profits.

If speculators are dominant in a marketplace and a general sense of speculative euphoria takes hold, then a self-reinforcing cycle can set in where speculative inflows of money drive prices up and rising prices attract the inflow of more speculative money. This force can become powerful enough, given the tremendous amount of money that institutional investors have at their disposal, that commodity prices can become elevated well above long-term equilibrium prices over long periods of time.

When bubbles occur in the capital markets, those people left holding the securities at inflated prices suffer when the bubble pops. When bubbles occur in the derivatives market for consumable commodities, it is potentially devastating for every person on the planet.

Americans do not eat a bowl of stocks for breakfast. They don't fill their gas tanks with bonds. Bubbles in the capital markets typically do not hurt the

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

average American as they are expanding. But when speculators drive up food and energy prices, it inflicts tremendous pain on innocent bystanders.

SOLUTION: AGGREGATE SPECULATIVE POSITION LIMITS

Price bubbles have become possible in the commodities derivatives markets because of the proliferation of loopholes and the general dismantling of speculative position limits. In recent years, the United States government (at the behest of Wall Street) has effectively dismantled the system of speculative position limits that protected our commodities derivatives markets for more than 50 years. The result has been an unleashing of excessive speculation upon the American consumer.

In order to effectively put the genie back in the bottle, we must close all of the existing loopholes that were signed into law by the Commodities Futures Modernization Act of 2000 (CFMA) and apply aggregate speculative position limits across all trading venues. The rest of this section is dedicated to discussing exactly how to do that.

A speculative position limit is a limit on the size of positions that speculators can hold. Take, for example, Wheat on the Chicago Mercantile Exchange (CME). A speculator cannot control more than 6,500 contracts (either long or short). The purpose of these limits is to prevent speculators, individually and collectively, from exercising too much influence over prices.

Problem 2(A): The Swaps Loophole

Prior to the CFMA, the Commodities Exchange Act (CEA) forbade the idea of over-the-counter (OTC) derivatives on consumable commodities, and required that all derivatives trading occur on a regulated futures exchange. After the CFMA was signed into law in 2000, OTC derivatives on consumable commodities were allowed to proliferate, and they did, rising from a notional value of \$389 billion in December 2000 to a notional value of \$12,389 billion in June 2008 (a greater than 3000% increase).¹³

Because some bona fide physical hedgers have chosen to use the OTC swaps market to hedge their physical commodity exposures, the CFTC has granted a blanket exemption to swaps dealers, giving them virtually free reign to buy and

¹³ Bank for International Settlements, "Semiannual OTC Derivatives Statistics," June 2008. <http://www.bis.org/statistics/derstats.htm>. Please note these figures do not include gold and other precious metals.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

sell enormous quantities of futures contracts without being subject to position limits.¹⁴

This is the swaps loophole: since swaps dealers have free reign to buy and sell in unlimited quantities, a hedge fund looking to speculate in a commodity like wheat (which still has position limits) can enter into a swap of unlimited size with a swaps dealer who can then access the wheat futures market, buying or selling wheat futures far in excess of position limits.

The CFTC justified this practice by saying that the swaps dealer is hedging risk like a bona fide hedger. But they failed to make the critical distinction that wheat farmers incur price risk while producing a valuable commodity used to feed the world, while swaps dealers incur price risk as they try to enrich themselves by serving as a conduit for speculators to avoid position limits.

To their credit, the CFTC has announced their intention to re-examine the swaps loophole and to look for ways to put more restrictions on swaps dealers' access to the futures markets.

Solution 2(A): Mandatory Exchange Clearing for Derivatives on Consumable Commodities Makes Aggregate Speculative Position Limits Simple to Implement

The best way to close the swaps loophole is to mandate that all OTC derivatives on consumable commodities clear through an exchange with novation and daily margin. As outlined earlier, mandatory exchange clearing needs to happen for all OTC derivatives in order to eliminate systemic risk. It is especially important for OTC commodity derivatives, because that will enable regulators to effectively close the swaps loophole by looking through the swaps transaction to the ultimate counterparty.

When an OTC derivative such as a swap clears through an exchange, the exchange breaks that transaction into its component parts and becomes the central counterparty to both sides of the trade. When this happens, both the swaps dealer and their counterparty become counterparties to the exchange. This enables regulators to see both sides of the OTC derivatives transaction. Currently, regulators only see the futures trades that the swaps dealer makes in order to hedge their OTC derivatives transaction.

¹⁴ Please note that while some regulated commodities futures markets still have stated position limits, many do not. On NYMEX for instance, position limits have been replaced by position "accountability" limits, which are really not limits at all.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Example of How a Swap Would Clear

Swaps are generally composed of a futures-equivalent position and one or more basis positions. Commodity futures are designed to have broad-based appeal in order to attract the most liquidity. For that reason they typically choose the most popular grade(s) of the commodity, the most popular delivery point(s) and the most popular delivery time(s). Futures contracts also have a standard number of units (bushel, barrels, etc).

Swaps and other OTC derivatives allow for changes to one or more of these factors. Those differences between the futures contract and the swap contract are called basis. Heating oil and jet fuel, for instance, are both closely related middle distillates produced from crude oil. They trade closely to one another but not identically. You have to adjust for those basis differences when you go to hedge or clear a swap.

Let's use a simple example of a commercial airline that wants to hedge its consumption of jet fuel through a monthly swap that extends for 24 months (2 years). Keeping it simple, let's assume this swap is for 420,000 gallons of New York Jet fuel each month. A futures contract is for 42,000 gallons so this is the equivalent of 10 futures contracts.

Therefore once the swaps dealer enters into this swap with the commercial airline, he will buy 10 NY Heating Oil contracts in each of the next 24 months to hedge himself. This will cover most of his risk but not 100% of his risk. If the swaps dealer wants to be fully hedged then he can also enter into a NY Heating Oil for NY Jet Fuel basis swap. This basis swap is a product that trades through NYMEX.

Example of Swap Components

| | | | | |
|---------------------------|---|---------------------------------|---|--|
| New York Jet Fuel Swap | = | New York Heating Oil Futures | + | NY Heating Oil for NY Jet Fuel Basis Swap |
|---------------------------|---|---------------------------------|---|--|

If the airline and the swaps dealer take their swap to NYMEX for clearing then NYMEX will break the trade down into its two parts. The airline will be long 10 NY Heating Oil contracts in each of the next 24 months plus long a NY Jet Fuel for NY Heating Oil swap in those same months. The swaps dealer will be short 10 NY Heating Oil contracts in each of the next 24 months plus short a NY Jet Fuel for NY Heating Oil swap in those same months.

When the swaps dealer's cleared swap position (short 10 contracts x 24 months) is matched with the NY Heating Oil futures that he purchased in order to hedge

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

(long 10 contracts x 24 months) then the two will cancel each other out and he will have eliminated all his futures-equivalent risk.

The swaps dealer will only be left with the basis risk from the NY Jet Fuel for NY Heating Oil position. If he wants to totally eliminate his risk he can enter into a basis swap in the OTC markets or through NYMEX. Once he does this then those trades will also clear and at that point the swaps dealer will have no position.

In the meantime, the commercial airline has the exact position that it wanted to have, which is long 420,000 gallons of New York Jet Fuel each month for the next 24 months. Its position just happens to be NY Heating Oil futures plus a NY Jet Fuel for NY Heating Oil basis swap. And now the airline's counterparty is no longer the swaps dealer but NYMEX.

The Costs of Clearing for Bona Fide Physical Hedgers Is Outweighed By The Benefits

Experts agree that once virtually all over-the-counter derivatives begin clearing through an exchange, then bid-ask spreads will narrow substantially due to heightened transparency. This will substantially reduce the costs of entering and exiting positions, and the relatively modest cost of clearing will easily be offset by the change in spreads. When swaps dealers lose their oligopoly pricing power, their customers will win in terms of better pricing.

Bona fide physical hedgers will be required to post margin collateral with the Central Counterparty (CCP), but that collateral will earn interest. So physical hedgers will only be financing the spread between their borrowing rate and the interest they earn on collateral. Every swaps dealer includes a cost of capital and a credit charge in their swaps pricing. This is partially due to the fact that swaps dealers have to post margin when they access the futures markets to hedge. Physical hedgers have been paying this cost in the OTC markets all along; they just have not been explicitly aware of it.

Once spreads narrow, then liquidity in the OTC markets will most likely increase. This is what we observed in the stock market's switch to decimal prices. Bid-ask spreads quickly collapsed from a quarter (25 cents) or an eighth (12.5 cents) down to one or two pennies routinely. This led to more trading and therefore more liquidity.

In addition because of the existence of a CCP, anyone can trade with anyone else. The fact that everybody's counterparty is the CCP means that credit risk is no longer a consideration and counterparties are not limited to trading with large money center banks. Electronic trading will make it possible for producers to trade directly with consumers with no swaps dealer as a middleman.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Finally, the biggest benefit of mandatory exchange clearing for consumable commodities is that clearing enables the markets to be protected against excessive speculation. The best method for applying aggregate speculative position limits is to require OTC derivatives to clear first. Without substantially all OTC derivatives clearing it becomes very difficult for the CFTC to make those position limits apply. The costs of another speculative bubble are orders of magnitude greater than any costs brought on by exchange clearing.

This Solution Allows CFTC to Leverage the Computational Processing Power of the DCO

Mandating that all OTC derivatives transactions in consumable commodities clear through an exchange solves the problem of how to apply aggregate speculative position limits in the OTC markets. Once the transactions clear, they are broken into their nearest futures contracts equivalents plus a minor basis position. When all OTC derivatives transactions in consumable commodities can be seen by regulators, then it becomes simple to apply aggregate position limits to speculators' positions.

It also means that swaps dealers' swap positions net out with the futures hedges that they have executed against those swaps positions. This means that swaps dealers will only face position limits when they are unhedged, since an unhedged position is the same thing as a proprietary trading position. This is the exact effect that regulators should be looking for.

Under this system, the DCO does all the computational "heavy-lifting" for the CFTC in terms of breaking down OTC derivatives transactions into their component futures equivalents and then netting exposures to arrive at a net position. If OTC derivatives transactions are not forced to clear, then the CFTC must perform all these computational tasks themselves (instead of the DCO) to be in a position to effectively look through swaps transactions and place position limits on speculators in the OTC derivatives markets. The CFTC will, in essence, be forced to assume many of the roles of a DCO.

Problem 2(B): The London Loophole

Some Foreign Boards of Trade (FBOT) trade contracts that are virtually identical to the futures contracts being traded on U.S.-regulated futures exchanges. As an example the Intercontinental Exchange (ICE), which is an Atlanta, GA-based company, has a London-based subsidiary (the former International Petroleum Exchange), which is currently regulated by the U.K.'s Financial Services Authority (FSA). ICE trades a WTI contract that actually cash-settles based on the NYMEX WTI crude oil settlement price.

This is called the "London Loophole" because the ICE WTI contract is essentially fungible with the NYMEX WTI contract. The ICE WTI contracts have no

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

speculative position limits and they are currently not subject to CFTC regulation. But because the two contracts are virtually identical, they are tightly bound by arbitrage trading.

The CFTC allows this regulatory arbitrage to continue, even though it is certainly within their power to regulate a commodity contract with a U.S. commodity (West Texas crude) and a U.S. parent company. In fact, any FBOT that wants to have trading terminals in the United States must get the permission of the CFTC to do so and that permission can be conditional on meeting any requirements that the CFTC deems necessary. Likewise, the CFTC has to sign off on any contracts that are to be traded by U.S.-based traders.

Solution 2(B): Require Foreign Boards of Trade to Submit Comparable Data and to Take Comparable Remedial Action for Violations

The solution to the London Loophole is simple. Foreign Boards of Trade must be required to supply all the same data that Designated Contract Markets (DCMs) provide to the CFTC, and they must be prepared to enforce speculative position limits by forcing speculators to reduce over-limit positions.

Anyone trading in U.S.-regulated derivatives markets, whether that is on a DCM or OTC should be required to obtain a Large Trader Identification Number (LTIN).¹⁵ In addition, that trader should be required by law to provide their LTIN to any FBOTs that they trade upon. If speculators want to trade in our markets then they should agree to provide their LTIN to any FBOTs that they trade upon. Any traders that fail to provide their LTINs when trading abroad should be banned from trading in the United States.

As a condition for allowing FBOTs to place their terminals in the United States and to trade with American citizens and corporations, they must agree to share large trader reporting data (including LTIN numbers) with the CFTC on a daily basis. If the CFTC determines that a trader is over their speculative position limits, then the FBOT must agree to take appropriate actions to remedy the situation.

Right now the possibility for cross-border regulatory coordination is at an all-time high. G8 energy ministers just issued a statement this week along with OPEC calling for greater regulation to crack down on excessive speculation in the energy markets.¹⁶ The United Nations and Asian energy ministers have made similar calls as well.¹⁷ It could be possible to establish a global large trader

¹⁵ I discuss LTINs in depth later in this testimony.

¹⁶ "G8 ministers lay course on energy security, efficiency," Silvia Marchetti, Xinhua, May 25, 2009

¹⁷ "OPEC, Asia May Call for Curbs on Speculation in Oil (Update2)," Shigeru Sato and Yuji Okada, Bloomberg, April 26, 2009.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

reporting system given the current desire for greater global coordination and regulation. The CFTC should be authorized to share similar information on large traders with other foreign regulatory authorities that want to establish similar systems to monitor aggregate speculative position limits.

Problem 2(C): The Enron Loophole

The Commodities Futures Modernization Act of 2000 (CFMA) arbitrarily created a new category of commodities called "exempt commodities." CFMA allowed exempt commodities to be traded on Exempt Commercial Markets (ECM), free from speculative position limits and most all of the CFTC requirements of Designated Commercial Markets (DCM).

The flawed belief was that there were some consumable commodities (such as crude oil) that had such large deliverable supplies that they were not susceptible to manipulation. This is a grave error for two reasons.

First, a commodity that has a large supply but a similarly large demand is balanced so tightly that it does not take a great amount of effort to manipulate the market for that commodity. Second, as I have already detailed, derivatives markets for consumable commodities are not just subject to manipulation, but to excessive speculation as well. This flawed concept completely ignores the critical element of excessive speculation, whereby prices can be dramatically affected even if there is no specific intent to manipulate.

Solution 2(C): Require Exempt Commercial Markets to Become Designated Commercial Markets

Enron pushed hard for the inclusion of exempt commodities and ECMs in the CFMA, which is why this is called the Enron Loophole. They used this loophole to create Enron Online and then they reportedly used Enron Online to manipulate electricity markets on the West Coast of the United States.

With Enron bankrupt and discredited and the flawed concept of ECMs exposed, it makes sense to simply do away with the ECM designation. All ECMs should be required to convert to Designated Commercial Markets or shut down operations.

Gold and Silver Can Remain Exempt Commodities

Exempt commodities should be defined within the Commodity Exchange Act as gold and possibly silver. While gold and silver are commodities consumed in industrial applications, they historically have been recognized as stores of value, and have been used as currency for thousands of years. Therefore, they are considered by most to be more like investments than other consumable commodities.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Gold and silver have historically represented valid investment vehicles, and therefore do not need to be protected from excessive speculation by position limits.¹⁶ If a bubble were to occur in the price of gold, it would not have the devastating impact to someone's health or the health of the economy the way bubbles in food and energy prices do.

CFTC Must Set Aggregate Speculative Position Limits for All Derivatives on Consumable Commodities

Fifteen years ago, when there was only one trading venue for consumable commodities and, in most cases, only one futures contract for each basic commodity, it was very simple to apply speculative position limits. Today, because there are multiple trading venues and multiple variations on each basic commodity, it has become necessary to develop a system of aggregating those positions together in order to apply an overall speculative position limit.

The goal with aggregate speculative position limits is simply to treat speculators equally regardless of which trading venue they select to trade in. The playing field needs to be leveled so that speculators are not given the incentive to engage in regulatory arbitrage and move their trading from one (more transparent or more regulated) venue to another.

The CFTC must set the aggregate speculative position limits for all consumable commodities in order to protect those derivatives markets against excessive speculation. Exchanges can continue to set position limits for financial futures to protect against manipulation (where their interest is aligned with the public interest) but they should not be allowed to set aggregate speculative position limits for consumable commodities. There are two primary reasons for this:

1. The futures exchanges (like CME group), which have become for-profit public companies, have a duty to shareholders to maximize profits. There is an inherent conflict of interest between their shareholders' interest and the public interest as a whole. The public interest would dictate that speculative trading be limited as much as possible while still maintaining sufficient liquidity. Since the futures exchanges profit based on the level of volume, their shareholders would like to see no speculative position limits at all.
2. Because futures exchanges are no longer the sole venue for trading derivatives on consumable commodities, they are not able to form a comprehensive speculative position limit that covers their competitors in addition to themselves.

The CFTC needs to identify speculative position limits for the nearest to expiration contract period, all other contract periods, and an overall limit for all

¹⁶ Like financial futures, gold and silver still need to be protected from fraud and manipulation.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

positions combined. As an example, in crude oil, perhaps speculators should be limited to holding no more than 1,000,000 barrels in the prompt month, 3,000,000 barrels in any other single month, and no more than 5,000,000 barrels in total. Speculative position limits should be expressed in the underlying units (barrels and bushels), rather than the number of contracts, since OTC derivatives positions will be included for determining the aggregate limits.

A distinction is drawn for the nearest to expiration contract period because it needs additional protection to prevent manipulation as the derivatives enter the delivery period. A limit is imposed upon each individual contract period in order to prevent a speculator from concentrating all its trading in one period. And the overall limit is imposed to prevent a situation of excessive speculation in the commodity as a whole.

A speculator that violates position limits by holding larger positions than the limits would allow must be prevented from adding to these positions. This means that those positions become "liquidation only" and they can be reduced but not added to. A speculator that repeatedly violates position limits can face stiff monetary penalties and the CFTC can force them to liquidate their positions (on a pro rata share across trading venues) until they fall back below the limits.

Issue All Large Traders an Identification Number at the Control Entity Level

When large traders fill out CFTC Form 40, they should be issued a Large Trader Identification Number (LTIN). This LTIN must then be associated with every trade that clears, whether that trade originated on a DCM, DTEF, FBOT or OTC. At the end of every trading day, every clearing organization (including foreign clearing organizations) must report the positions of all large traders according to their LTIN. This accomplishes two things. First and foremost, the positions can be compiled by LTIN to see if any speculators are exceeding position limits. It also allows for the Commitments of Traders data to be collected daily instead of weekly.

Large Trader Identification Numbers (LTIN) must be issued at the control entity level. For instance one hedge fund gets one LTIN. Speculators cannot be allowed to create multiple shell subsidiaries in order to obtain multiple LTINs.

Bona fide physical hedgers who fill out Form 40 should also be issued LTINs. As part of Form 40, they should be required to indicate (under penalty of perjury) the size of their physical commodity business and whether they are selling commodities, buying commodities or both (middlemen). The LTIN can then be used to make sure that these physical hedgers are in fact hedging and not just speculating in the markets. For instance, an oil producer (who is long the price of oil to begin with) should not be allowed to establish a net long position in futures

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

contracts. Nor should they be allowed to establish a net short position that exceeds the size of their underlying business.

Positions Should Be Aggregated for the Basic Commodity

Any time there is a strong relationship between substantially similar commodities then those commodities should receive one aggregate position limit for the purpose of limiting excessive speculation. As an example, wheat is wheat, whether it's soft or hard, spring or winter, it's still wheat. Crude oil is crude oil, whether it's heavy or light, sweet or sour, it's still crude oil. If the price of light sweet crude skyrockets then that is going to have a substantial impact on the price of heavy sour crude. If the price of soft red winter wheat crashes, then that is going to have a substantial impact on the price of hard red spring wheat.

This is not to say that there are no differences between these commodities, but rather that the differences are extremely well-known and that is why there is a great deal of basis trading and arbitrage trading that takes place between substantially similar commodities. Any time there is arbitrage or basis trading there is a strong price discovery relationship. These basis and arbitrage trades are what "enforce" the relationship between these commodities and it is for this reason that they should be aggregated together under one speculative position limit.

As an extreme example, if a speculator wanted to buy 1 billion barrels worth of NYMEX WTI crude oil futures contracts, but was prevented from doing so by speculative position limits, and they purchased 1 billion barrels worth of ICE Brent crude oil futures contracts instead, then that would push up the price of ICE Brent. But it would also push up the price of all other crude oil contracts around the world, because a large fraction of the people selling those 1 billion barrels worth of ICE Brent would be arbitrageurs and basis traders who would be selling ICE Brent and simultaneously buying WTI, Dubai Sour, et cetera. Having speculative position limits on the NYMEX would go a long way to blunt the impact of this arbitrageur/basis trader buying (as long as those traders were not given exemptions from speculative position limits). But even with speculative limits, there are enough of these types of traders that it would be impossible for large magnitude price moves in ICE Brent not to have a significant effect on NYMEX WTI prices.

For this reason, the speculative position limits should be set for the commodity as a whole (crude oil) rather than for one particular grade or delivery location. One practical benefit of this approach is that exemptions for basis trading and arbitrage are not necessary because both legs of their trades fall under the same umbrella speculative position limit and therefore net each other out.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The 2008 Farm Bill introduced the concept of "significant price discovery" contracts. This gives the impression that it is somehow possible for two contracts on the same commodity to not have a significant impact on each other. However, this is not possible whenever arbitrage trading is occurring. The arbitrage and basis relationships between substantially similar commodities ensure that they always significantly affect one another from a price discovery standpoint.

Positions Should Be Aggregated Across Trading Venues

In our above example dealing with NYMEX WTI and ICE Brent, we talked about how two venues trading different grades of crude oil would still have a strong price discovery relationship binding them together. This relationship would be even stronger (virtually one for one) if we are talking about NYMEX WTI and ICE WTI where the deliverable grades are identical and one contract cash-settles against the other. Right now there are no hard and fast speculative position limits in either contract (except for the last 3 days on the NYMEX) so those two contracts are bound at the hip by arbitrage.

We gave another example earlier of an airline that approaches a swaps dealer about hedging their jet fuel exposure by entering a swap for 420,000 gallons of jet fuel per month for the next 24 months. To hedge this swap, the swaps dealer has two options: (1) they can go to the NYMEX and buy 10 heating oil contracts in the each of the next 24 months or (2) they can find a refiner that wants to hedge their jet fuel (or heating oil) production by entering into a swap to sell 420,000 gallons of jet fuel per month for the next 24 months.

In either case this swap has a direct price discovery impact on the futures market resulting in either 10 more heating oil contracts on the long side (if the swaps dealer hedges directly on the futures exchange) or 10 fewer heating oil contracts on the sell side (if the refiner hedges in the OTC markets rather than on the futures exchange).¹⁹ So it is clear from these two examples that the derivatives market for consumable commodities has multiple venues that are really just extensions of one another.

Because the trading venue does not matter in terms of the overall price effect on the market as a whole, speculative position limits need to be aggregated across trading venues. The objective is to simply level the playing field and treat all speculators equally regardless of whether they trade on a DCM, DTEF, FBOT or OTC.

¹⁹ Please note that if one swaps dealer trades with another swaps dealer, then the first dealer has simply passed along the problem of how to hedge to the second dealer.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

Congress Should Define Excessive Speculation and Charge the CFTC with Enforcing an Overall Limit on the Amount of Speculation Present in the Derivatives Markets for Each Basic Commodity

The Commodity Exchange Act (CEA) does not clearly define the concept of excessive speculation. Perhaps Congress believed that the term was self-explanatory, simply meaning "too much speculation." But since the concept was not clearly defined, swaps dealers and the futures exchanges have been able to redefine it to mean something more akin to manipulation.

For that reason, I would propose that Congress amend the CEA to clearly state that excessive speculation is a condition of the derivatives markets for consumable commodities wherein speculators are a more dominant force in price discovery than bona fide physical hedgers. And when a state of excessive speculation exists, it is possible for speculative price bubbles to form.

Since a speculative price bubble in consumable commodities is potentially devastating to humanity, I believe Congress should mandate a percentage of open interest calculation to ensure that the positions held by speculators never exceed the positions held by bona fide physical hedgers (50% of the market). Then Congress should instruct the CFTC to adjust the individual speculative position limits so that the overall speculation percentage of the markets lies in the range of 15% - 35%.

Please note that the average consumable commodity futures market was about 25% speculative ten years ago.²⁰ It is only in the last ten years that we have seen a surge in speculation to the point where speculators now dramatically outnumber bona fide physical hedgers in many markets. With that surge in speculation has come a surge in the volatility of commodity prices – last year's bubble in crude oil prices being the primary example. We need sufficient liquidity in these markets, but we don't need excessive liquidity because that leads to excessive speculation and excessive price volatility.

With the proliferation of the Internet and electronic trading facilities, it is much easier for physical producers and consumers to transact amongst themselves without the need for speculators' liquidity. That is why 25% might be more than enough speculation to provide the markets with sufficient liquidity.

If there is too much speculation in the overall derivatives market for a consumable commodity (say 40%), then the individual speculative position limits must be adjusted downward to reduce the overall level of speculation. This can be accomplished through a series of "circuit breakers" which would be designed to keep overall speculation within a targeted range.

²⁰ These calculations can be found on pages 33-34 of our report "The Accidental Hunt Brothers" www.accidentalthuntbrothers.com

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

CFTC Should Semi-Annually Convene a Hearing of Physical Commodity Producers and Consumers to Recommend Aggregate Speculative Position Limits and an Overall Market Percentage for Speculation

To recognize the foundational fact that derivatives markets for consumable commodities exist solely to enable bona fide physical producers and consumers to hedge their price risk, Congress should mandate that the CFTC semi-annually convene a hearing of physical producers and consumers. These producers and consumers (for whom these markets exist) know whether or not the markets are working for them and whether or not they need more liquidity or less speculation. They are therefore in the best position to recommend aggregate speculative position limits for each commodity and also a target for an overall speculation percentage in that commodity derivatives market. The CFTC should adopt those recommendations or provide a detailed formal response to Congress as to why they are rejecting the proposals.

Congress Should Give the CFTC Explicit Power to Police OTC Commodities Derivatives Markets for Fraud and Manipulation

If OTC derivatives are allowed to trade off-exchange then the CFTC must be given explicit powers to police the consumable commodities OTC derivatives markets for fraud and manipulation. Commodities futures are fully regulated by the CFTC against fraud and manipulation. The physical energy markets are regulated by the Federal Energy Regulatory Commission (FERC) and Federal Trade Commission (FTC) for fraud and manipulation in natural gas/electricity and oil respectively. Therefore it makes sense that the OTC markets be regulated for fraud and manipulation as well. In the end, all regulatory arbitrage of this sort should be eliminated.

Passive "Investment" In Derivatives on Consumable Commodities is a New and Very Damaging Threat to the Markets

As mentioned earlier, the distinctions between financial derivatives and derivatives on consumable commodities have been blurred. Wall Street has pulled the wool over institutional investors' eyes and convinced them that derivatives on consumable commodities are a legitimate "asset class" and that it is possible to "invest" in commodities futures.

Derivatives have no value in and of themselves. All their value is derived from the underlying asset. In the case of consumable commodities, what is underlying these contracts are not securities or capital markets instruments, but the food and energy that Americans need to consume in order to survive and thrive.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

I hope that the U.S. government would not allow investors to buy up actual food or actual crude oil and hoard them because they are deluded into thinking they are making a good investment. We need those commodities to feed ourselves and fuel our economy. If investors, therefore, cannot "buy and hoard" the underlying commodities, then they should not be allowed to "buy and hold" the derivatives on those commodities.

Derivatives on consumable commodities do not pay interest, dividends or rents, and they have no associated cash flows because the underlying commodities have none of these things. In fact, in many cases consumable commodities have transportation and storage costs and decay over time, which means the "yield" from holding these commodities is negative.

Speculators are permitted in the derivatives markets for consumable commodities only because they provide liquidity. If someone attempts to "buy and hold" a position in commodity futures by continuously rolling it then that speculator is consuming liquidity. They have bought that contract perhaps from a bona fide physical producer and then rather than selling it to a bona fide physical consumer they hold onto it for "the long term."

Because these passive investors are almost always buying, their buying pressure pushes prices up. And since they are holding for the long term, it could be years and years before they sell. In the meantime, if enough people buy and hold, prices will increase and remain elevated for a long period of time.

Commodity index investment is an especially damaging form of passive investment that entails the buying and holding of a large basket (index) of consumable commodities derivatives. These investors do not trade on the basis of supply and demand. Instead, they blindly allocate money to crude oil, copper, corn, et cetera, which all have vastly different supply and demand dynamics.

Every barrel or bushel traded for reasons other than supply and demand is a barrel or bushel that distorts the price discovery function of the consumable commodities derivatives markets. Someone who buys one or more consumable commodities derivatives with the express intention of "hedging against inflation" damages the price discovery function of those markets by investing without regard for the underlying supply and demand conditions. In buying commodities futures, that misguided investor is actually causing inflation by pumping up commodity prices.

Passive "Investment" in Consumable Commodities Should Be Severely Restricted

For the reasons I just detailed, passive investment in these markets should be severely restricted. It is simple to define what constitutes passive investment. It

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

is a trading strategy that calls for maintaining a continuously long (or short) position in a consumable commodity.

Passive investors should face aggregate speculative position limits that are 10% or less than the limits faced by actively trading speculators. So, as an example, if the aggregate speculative position limit is 5,000,000 barrels for crude oil, then passive investors should only be allowed to buy and hold a maximum of 500,000 barrels of crude oil derivatives.

This also means that the levels for what constitutes a reportable position, for large trader reporting and identification purposes, should be reduced by a commensurate amount. So, as another example, if any speculator over 250,000 barrels typically needs to report their position then any passive investor over 25,000 barrels should be forced to report.

This regime of much tighter aggregate speculative position limits needs to apply to exchange traded funds (ETFs), exchange traded notes (ETNs), any other hybrid securities, as well as to commodity-based mutual funds. Any individual who wants to buy ETFs, ETNs or mutual funds that represent a passive investment in consumable commodities should be required to fill out Form 40 and obtain a Large Trader Identification Number (LTIN) before they can place their order.

The Commodities Futures Trading Commission (CFTC) Has the Experience and Skills to Implement these Recommendations and the Securities and Exchange Commission (SEC) and Federal Reserve (Fed) Do Not

In order to eliminate systemic risk and effectively implement a system of mandatory exchange clearing with novation and margin, we need regulators who are intimately familiar with the novation and margin processes. Futures exchanges have been novating contracts and assessing margin for over 140 years. The CFTC and its predecessors have been regulating these processes for over 70 years.

In contrast, the clearing processes for securities simply involve the transfer of money in exchange for the securities themselves. They do not involve novation or daily margin posting. Therefore, the SEC lacks the experience necessary to effectively regulate these areas. So does the Federal Reserve, who allowed the shadow financial system to proliferate under their watch and only intervened after the system began to crumble.

In addition, the CFTC and its predecessors have been imposing speculative position limits for over 70 years. They are the only regulator who has ever been charged with guarding the markets against excessive speculation.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

The SEC presides over the capital markets where everyone is a speculator. They are unfamiliar with the concept of excessive speculation and have little experience with setting and enforcing position limits.

In fact in a gross example of regulatory arbitrage, the SEC has allowed passive commodity investments in ETFs, ETNs and commodity mutual funds. They have signed off on double-leveraged crude oil ETFs (like DXO) that allow any investor to make leveraged speculative investments in crude oil within their retirement accounts. This does not show good judgment from a consumer protection or a market protection standpoint.

The Federal Reserve has little experience in regulating commodities markets and setting speculative position limits. Most banks are forbidden to participate in the physical commodities markets, although the Federal Reserve has granted exemptions for the big commodities swaps dealers like Goldman Sachs, Morgan Stanley and J.P. Morgan. Since all banks would naturally be characterized as speculators in the commodities derivatives markets, the Federal Reserve seems like an illogical choice for guarding these markets against excessive speculation.

For these reasons, the CFTC is the best regulator to police the consumable commodities derivatives markets. They also are the best choice for overseeing the mandatory exchange clearing of the OTC derivatives markets as a whole because of their experience with novation and daily margin posting.

SUMMARY

In summary, let me say that the solutions I have outlined in my testimony are not brand new solutions. (1) Exchange clearing with novation and margin, and (2) speculative position limits have been proven effective over many decades of experience. In many ways, what we need to do is turn back the clock on several of the deregulatory measures that were undertaken in the last 15 years. The unintended consequences of those deregulatory decisions have been devastating for America.

I applaud you, Senator Harkin, for what you are trying to do with your recently introduced legislation. It appears that your legislation effectively slams the door shut on the loopholes that the Commodities Futures Modernization Act of 2000 opened up. There is no doubt that your legislation, because it requires mandatory exchange trading and therefore mandatory exchange clearing, would protect the financial system and eliminate the chance of another systemic meltdown. Likewise with all speculators trading on an exchange it would be simple for the CFTC to impose speculative position limits that treated them all the same.

Testimony of Michael W. Masters - Senate Agriculture Committee - June 4, 2009

I believe the solutions that I have proposed in my testimony today would accomplish the same primary objectives as your legislation, while allowing the over-the-counter (OTC) derivatives markets to survive. I applaud you for your leadership on this issue and I look forward to working with you and your staff to ensure that America does not have to suffer through another financial meltdown or another speculative bubble in food and energy prices.

UNIVERSITY OF CALIFORNIA, LOS ANGELES



UCLA

BERKELEY • DAVIS • IRVINE • LOS ANGELES • MERCED • RIVERSIDE • SAN DIEGO • SAN FRANCISCO

SANTA BARBARA • SANTA CRUZ

LYNN A. STOUT
PAUL HASTINGS PROFESSOR OF CORPORATE AND SECURITIES LAWSCHOOL OF LAW
405 HILGARD AVENUE
BOX 951476
LOS ANGELES, CALIFORNIA 90095-1476
PHONE: (310) 206-8402
FAX: (310) 206-2122
E-MAIL: stout@law.ucla.edu

June 4, 2009

United States Senate
Committee on Agriculture, Forestry and Nutrition
Washington, DC 20510-6000

Dear Committee Members,

Thank you for inviting me to testify today. My name is Lynn Stout, and I am the Paul Hastings Professor of Corporate and Securities Law at the University of California at Los Angeles. My scholarly expertise includes the theory and history of derivatives regulation. I also serve as an independent director of a large mutual fund, giving me practical experience in the derivatives market. I have also published several academic articles on the topic of derivatives regulation.¹ Please allow me to note that my articles on derivatives, which I published in the 1990s, predicted that deregulating financial derivatives was likely to result in increased market risk, reduced investor returns, and price distortions and bubbles.² Those predictions, unfortunately, have proven correct.

Studying the history and theory of derivatives regulation inevitably leads to four basic conclusions. First, despite industry claims, derivative contracts are not new and are not particularly innovative. Although derivatives have gone by many different names, derivatives trading in the United States dates back at least to the early 1800s, and in other nations, centuries earlier. The 1884 Supreme Court case of *Irwin v. Williar*, for example, describes the contract law rules that applied to derivatives contracts in the 19th century. (They were then called "difference contracts.")³

Second, derivatives trading may provide some benefits to the overall economy. It is important to note, however, that while the industry routinely claims the social benefits from derivatives trading are substantial, there is no empirical evidence that supports this claim or establishes the magnitude of the supposed social benefits. At the same time, throughout history, unregulated derivatives markets have been associated with at least four distinct economic dangers. First, unregulated trading has been associated with asset price bubbles. Second, it has been associated with increased risk. Third, derivatives speculation has been criticized for reducing real economic productivity by diverting valuable resources, especially human time and creativity, away from industries and activities that contribute more to sustainable economic

¹ See e.g., Lynn A. Stout, *Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets*, 21 J. Corp. L. 53 (1995); Lynn A. Stout, *Insurance or Gambling? Derivatives Trading in a World of Risk and Uncertainty*, 1996 Brookings Rev. 39 (Winter); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L. J. 701 (1999).

² See, e.g., Stout, *Why the Law Hates Speculators*, 48 Duke L. J. 769-771 (arguing that making over-the-counter "OTC" financial derivatives exempt from the Commodities Exchange Act may erode average returns, increase market risk, and lead to price distortions and market bubbles).

³ 110 U.S. 499 (1884).

growth and to social welfare. Fourth, derivatives trading has been associated with increased levels of fraud and manipulation in underlying markets.

A third basic conclusion that can be drawn from studying the history of derivatives is that healthy economics regulate derivatives trading. My research indicates that the only time a significant US derivatives market has not been subject to regulation was during the eight years following the passage of the Commodity Futures Modernization Act of 2000 (CFMA). Although it was not widely appreciated at the time, the CFMA eliminated more than a century of legal restraints on derivatives trading by declaring that over-the-counter (OTC) financial derivatives were not subject to traditional contract law rules and were not subject to the Commodity Exchange Act (CEA) or the oversight of the Commodity Futures Trading Commission (CFTC).

Fourth, history teaches that successful derivatives regulation generally does not take the form of either a heavy-handed ban on all derivatives trading, or direct monitoring by some omniscient government overseer. Traditionally, derivatives markets have been successfully regulated through a web of procedural rules that include reporting requirements, listing requirements, margin requirements, position limits, insurable interest requirements, and limits on enforceability. These sorts of rules can be put in place ex ante, reducing the need for government to exercise discretion and giving derivatives traders certainty about what is and is not required of them. The rules also have the advantage of operating largely as automatic "circuit breakers" that make it unnecessary for regulators to have either initiative or omniscience. Finally, these traditional rules have a long track record of success (dating back decades and in some cases centuries) in permitting beneficial forms of derivatives trading while weeding out excessive risk, speculation, and manipulation. The most obvious recent example is the notable success that the CFTC has had since 1974 in preventing excessive speculation in the markets for commodities derivatives.

An Introduction to Derivatives

Let me begin by explaining that, although Wall Street often surrounds derivatives contracts with jargon that makes them seem complex and difficult to understand, derivatives are quite simple. A derivative contract is nothing more than a bet or gamble on what is going to happen in the future. Just as you might place a bet on the horse you expect to win a horserace (your betting ticket is your derivative contract), you can bet on future interest rates by entering an interest rate swap contract, or bet on a company's future creditworthiness by entering a credit default swap contract.

Until the 19th century, most derivative contracts were bets on the future prices of agricultural commodities, such as the rice derivatives traded in Japan in the 15th century and the commodities futures and options traded under the oversight of the CFTC today. To use the language of derivatives traders, the "underlying"—that is, the thing being bet upon—was the price of rice, wheat, or corn.

Financial derivatives, which became common in the U.S. in the 1800s, are simply derivative bets where the "underlying" is an interest rate, currency exchange rate, credit rating, or securities price, rather than wheat or corn. The first financial derivatives in the U.S. appear to have been stock options and futures, essentially derivative bets on the future prices of corporate stocks. The 1990s have seen an explosion in other forms of derivatives contracts, including derivative contracts on interest rates (interest

rate swaps), credit ratings (credit default swaps), and even weather derivatives. Contrary to industry claims, the development of large markets in financial derivatives was not the result of some new idea or "innovation." Rather, it was the result of the steady deregulation of financial derivatives trading.

Using Derivatives: Hedging or Speculation?

Derivatives trading can provide economic benefits. Most importantly, derivative bets can, at least in theory, be used as a form of insurance to hedge against risk. For example, if you own a corporate bond and you are worried the bond might decline in value, you can purchase a credit default swap that offsets your risk, because the swap will increase in value if the bond decreases in value. This is true hedging, and it serves a useful purpose by reducing risk.

But it is essential to recognize that derivative bets are also ideally suited for pure speculation. The economic literature defines speculation as the attempt to profit not by producing something or by providing investment funds to someone who is producing something, but by predicting the future better than others predict the future.⁴ Just as you can make money from predicting the outcome of a horse race without actually owning a horse, you can make money betting on the fate of a company by buying credit default swaps (CDS) without ever buying stocks or bonds that would actually provide investment funds to the company. In both cases, you are not contributing anything either to the welfare of the horse, or to the welfare of the company. And in both cases, you are increasing your risk level by making the bet, just as a gambler increases her risk level when she goes to the track.

Derivatives speculation may provide modest social benefits by increasing liquidity for the underlying and by marginally improving the accuracy of the market price for the underlying ("price discovery"). Again, however, while the industry routinely claims these benefits are substantial, no empirical evidence exists to support this claim. Without doubt, derivatives speculation can also provide very large financial benefits for individual traders (offset by some counterparty's loss), just as gambling can provide large benefits for individual gamblers (offset by some other gambler's loss). These speculative trading gains are purely private benefits, however, that come at other investors' expense. Meanwhile, unrestrained derivatives speculation has historically been linked to a host of very serious economic ills, including price bubbles and crashes, increased risk, reduced real economic growth, and increased fraud and manipulation.

This is probably why virtually every derivatives trader claims that he or she is using financial derivatives for hedging, not for speculation.⁵ This is also why hedge funds call themselves hedge funds, so as to create an impression they are not speculators trying to profit at the expense of average investors. In fact, it can be difficult to prove with certainty that any particular derivatives trade is not a hedge, because traders are usually clever enough to hypothesize some underlying risk they are supposedly exposed to that

⁴ See Lynn A. Stout, *Irrational Expectations*, 3 Legal Theory 227 (1997)(discussing theories of speculation).

⁵ In some cases, derivatives traders claim they are "hedging" when in fact they are using derivatives to offset some of the risk associated with taking a speculative position they would not have taken but for the availability of derivatives. This is the equivalent to a racetrack gambler claiming she is "hedging" when, in addition to betting on a horse to win, she also buys a ticket for win-place-show. In other cases, derivatives traders may have mistakenly thought they were hedging because they relied too much on the supposed accuracy of some "risk management" model.

the derivative supposedly offsets. Nevertheless, it is clear that by 2008, the market for CDS, for example, was primarily a speculative market.

We know this with mathematical certainty because by 2008, the notional value of the CDS market (that is, the dollar value of the bonds on which CDS bets had been written) had reached \$67 trillion.⁶ At the same time, the total market value of the underlying bonds issued by U.S. companies outstanding was only \$15 trillion.⁷ When the notional value of a derivatives market is more than four times larger than the size of the market for the underlying, it is a mathematical certainty that most derivatives trading is speculation, not hedging. And both economic theory and business history associate speculative markets with serious negative economic consequences.

Economic Problems Associated With Excessive Speculation

In particular, when a derivatives market becomes overwhelmed by speculation, we can expect to see several bad things happen. First, we can expect to see asset price bubbles and crashes. In effect, expectations in the speculative market, where derivatives gamblers can make very large bets using very small amounts of money, come to infect prices in the underlying market. An early example of this was the famous Dutch tulip bulb bubble of 1637, in which trading in newly-invented tulip bulb derivatives triggered a sudden increase and equally sudden crash in tulip bulb prices.⁸

Second, excessive speculation adds to systemic risk, because individual speculators lose or gain large amounts of money unexpectedly. The best recent example of this is the case of AIG, where speculation in CDS on the part of AIG traders who believed they could predict the future creditworthiness of corporate borrowers led to large and unexpected derivatives trading losses which threatened AIG's economic health, in turn threatening the health of AIG's trading partners. The result was a "domino effect" that threatened the stability of the banking system.

Third, excessive speculation reduces overall economic performance by draining valuable resources, including valuable human capital, away from more productive uses. Professor Simon Johnson of MIT's Sloan School of Management estimates that between 1973 and 1985, the financial sector of the US economy never earned more than 16 percent of U.S. domestic corporate profit. During the past decade, however, the finance sector took in as much as 41 percent of all corporate profit.⁹ Much of this profit reflects trading gains reaped by hedge funds and proprietary trading divisions of investment banks, which enjoyed these gains at the expense of average investors. Put differently, while derivatives speculation can be very profitable for individual speculators, from a social perspective it is a zero-sum game that consumes valuable social resources while making little or no contribution to social welfare or average investor returns.

⁶ Bank for International Settlements, *Quarterly Review Statistical Annex* at A103 Table 19 (Amounts Outstanding of Over-the-Counter (OTC) Derivatives) (December 2008).

⁷ *Id.* at A97, Table 16B (Domestic Debt Securities).

⁸ See Peter M. Garber, *Tulipmania*, 97 J. Pol. Econ. 535 (1989).

⁹ Simon Johnson, *The Quiet Coup*, *The Atlantic* (May 2009).

Fourth, the opportunity to trade freely in derivatives encourages fraud and price manipulation in the market for the underlying. To see why, assume a derivatives trader can easily buy \$100 million in CDS on a public company with \$20 million in outstanding stock. By spending just over \$10 million to buy a majority of the company's shares, then using its shareholder position to cause the company to pursue strategies that destroy value, the derivatives trader can reap an enormous profit on its \$100 million CDS trade which more than offsets the decline in the value of its \$10 million equity investment.

Regulating Derivatives: The Lessons of Experience

The economic dangers of derivatives first captured public attention in 1994, when Proctor & Gamble Co. announced an unexpected \$157 million dollar loss from speculative trading in interest rate swaps. Of course, Proctor & Gamble's loss was soon followed by much larger derivatives trading losses, including those that led to the collapse of Orange County's pension fund and of Barings Bank in the 1990s; to the near-collapse of Long Term Capital Management in 1998; to Enron's bankruptcy in 2001; and most recently, to the collapse of Bear Stearns and AIG in 2008.

Why did these losses occur? As we have seen, derivatives trading was not new. What was new, however, was that beginning in the early 1990s, trading in financial derivatives was increasingly made free from any sort of regulation. For example, in the 1990s, the CFTC granted a regulatory exemption from the Commodities Exchange Act for certain forms of financial derivatives, especially interest swaps. When the CFTC subsequently attempted to extend its jurisdiction to other types of financial derivatives, it was rebuffed by Congressional passage of the CMFA of 2000. The CMFA not only exempted most OTC financial derivatives from CFTC oversight, it also reversed, for the first time in American legal history, long-standing common law rules limiting their legal enforceability.

The unfortunate results of this deregulation are now obvious. How should lawmakers respond?

History teaches that there are a wide variety of well-developed, sophisticated, time-tested regulatory tools that can be brought to bear on the problem of regulating financial derivatives. These tools can protect the legitimate use of derivatives for hedging purposes, while discouraging excessive speculation. They do not require us either to ban all derivatives trading, or to attempt to subject derivatives markets to the oversight of a centralized, all-powerful regulator tasked with intervening on an ad hoc, discretionary basis. To the contrary, derivatives markets can be successfully regulated through a variety of regulatory requirements that do not prohibit derivatives trading but do subject trading to various reporting requirements, listing requirements, margin requirements, position limits, insurable interest requirements, and limits on enforceability. The obvious prototype for this regulatory approach is the successful regulation of commodities derivatives by the CFTC under the authority of the CEA. This approach has a number of advantages, including its emphasis on ex ante rules that provide certainty for traders: its reliance on automatic "circuit breakers" rather than agency discretion; and its time-tested success.

When it comes to regulating financial derivatives, there is no need to re-invent the regulatory wheel. The economic problems associated with financial derivatives are neither novel nor unique. They exist in any market prone to speculation. Similarly, the challenges associated with regulating speculation in financial derivatives, including the challenges of protecting legitimate hedging transactions and preventing speculative trading from migrating to other jurisdictions, are not unique. Logic and history suggest they

can be successfully addressed by the same sorts of regulatory rules we have employed, to great effect, in other markets prone to excessive speculation.

Lynn A. Stout
Paul Hastings Professor of Corporate Law and Securities Regulation
UCLA School of Law.

DOCUMENTS SUBMITTED FOR THE RECORD

JUNE 4, 2009

(137)

Exchanges Warn On OTC Clearing

Financial Times - June 3 2009 18:01

By Jeremy Grant in London

Three of the world's largest exchanges have warned regulators and lawmakers not to force too much of the over-the-counter derivatives markets into clearing houses, saying that market participants should have a role in deciding how far such products are shifted away from the opaque privately negotiated markets.

The comments on Wednesday, by executives at NYSE Liffe, Intercontinental Exchange and London Stock Exchange, come from businesses that are likely to be the main beneficiaries of a push by the Obama administration to ensure more OTC derivatives are cleared and traded on exchanges and other regulated trading platforms.

Tim Geithner, US Treasury secretary, has called for more OTC derivatives to be processed through clearing houses to reduce the counterparty risks associated with defaults, and for "standardised" OTC contracts to be traded on-exchange.

But exchanges, many of which own their own clearers, are concerned that legislation written by the US Congress should not go so far as to force the more complex, tailored OTC derivatives into clearing houses that are ill-equipped to deal with the risks associated with them.

In particular, they are concerned about how the unwinding of positions would be handled with such products, many of which are illiquid compared with standardised products.

Mark Ibbotson, chief operating officer at NYSE Liffe, the futures arm of NYSE Euronext, said: "The plea we'd have is mandates are kept to a minimum. Is it right that every [OTC derivatives] product should be put in a straitjacket on an exchange?"

"It could damage the security of a clearing house to force products on to a clearing house that shouldn't be there. We don't want mandated solutions, let's have us working with the market," Mr Ibbotson said at the Mondo Visione Exchanges Forum.

David Peniket, chief operations officer of ICE Europe, part of the US-based Intercontinental Exchange, said it was important to involve market participants in how far clearing is extended to the OTC markets.

He cited the gradual adoption by market participants of clearing in OTC energy markets after Enron's collapse.

ICE started offering clearing of OTC energy products in the early 2000s. The New York Mercantile Exchange, now owned by CME, launched Clearport, a similar service, in 2002.

"Regulators will certainly have markets that they want to encourage into clearing but I think it's very important to let markets develop their solutions," he told the Financial Times. "There is certainly a concern around mandatory solutions, that you damage liquidity."

Adam Kinsley, head of regulation at LSE, said: "The onus is on exchanges to develop commercial offerings that people want to use, and I don't think it's the right way for regulators to force inappropriate products on-exchange."



Jennifer M. Grigsby
*Senior Vice President,
 Treasurer and Corporate Secretary*

May 28, 2009

Mr. Timothy F. Geithner
 Secretary of the Treasury
 1500 Pennsylvania Avenue, NW
 Washington, D.C. 20220

Dear Secretary Geithner:

Chesapeake Energy Corporation, the nation's largest independent producer of clean-burning, American natural gas, would like to thank the Administration for striving to achieve worthy goals of transparency, accountability and market efficiency in the over-the-counter (OTC) derivatives market. Following your recent proposals and those of federal lawmakers, we appreciate the opportunity to offer the following comments and proposals.

In your May 13, 2009, letter to Capitol Hill, you outlined the objectives for government regulation of the OTC derivatives markets following consultations with the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC) and other federal regulators. The goals were the following: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. As a company that extensively utilizes OTC commodity derivatives as a vital risk-management tool, **we also strongly support transparency, accountability, and market integrity.**

However, the letter goes on to say that "to contain systemic risks, the CEA (Commodity Exchange Act) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs)" with "robust margin requirements and other necessary risk controls and to ensure that customized OTC derivatives are not used solely as a means to avoid using a CCP. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCP, it should create a presumption that it is a standardized contract and thus required to be cleared."

Subsequent to reviewing the above proposal and others outlined in your letter, as well as legislation introduced in both the House and Senate (specifically, H.R. 977 by House Agriculture Committee Chairman Peterson and S. 272 by Senate Agriculture Chairman Tom Harkin), we have serious concerns about the impact these proposals would have on responsible, credit-worthy non-speculating end-user companies like Chesapeake Energy that hedge only the physical products we produce. Yet we also have areas where we support responsible reform to achieve the goals.

Chesapeake Energy Corporation Concerns

To begin, I would like to clarify several important points based on misconceptions we have heard.

Chesapeake Energy Corporation
 P.O. Box 18496 • Oklahoma City, OK 73154-0496 • 6100 N. Western Avenue • Oklahoma City, OK 73118
 405.879.9225 • fax 405.879.9576 • jennifer.grigsby@chek.com

- (1) First, it must be understood that the cash requirements of clearing OTC derivatives on an exchange would prove to be a significant liquidity drain on American companies that are using these contracts for prudent risk-management purposes. At a time when the U.S. economy needs more free-floating capital, posting cash margin on an exchange would prove to have the opposite effect, in fact, risking a more serious liquidity crisis. Chesapeake Energy invests more than 100 percent of our free cash flow into finding and producing clean-burning, American natural gas. The primary objective of our risk-management policy is to provide for cash-flow certainty and stability so we can responsibly plan and execute our future business strategy. A requirement to post cash would inject cash uncertainty into our business model and, thus, reduce our ability to explore for and produce natural gas.

For example, on June 30, 2008, our negative "mark-to-market," or what we owed our counterparties for natural gas hedging transactions, which were outstanding but not yet matured, was about \$6.3 billion. If our company had been forced to immediately fund such an enormous cash margin requirement, our company, which officially discovered what is known as the Haynesville Shale that same year, potentially the most significant natural gas field ever discovered in North America, would not have had the liquidity to invest in this new play. Additionally, by December 31, 2008, the natural gas market had reversed and our \$6.3 billion negative mark-to-market became a positive \$1.3 billion mark-to-market. In short, requiring cash to be posted on an exchange defeats the purpose of using OTC derivatives, which is to provide cash certainty for investing in the future.

- (2) Furthermore, we understand another significant concern about the OTC derivative market is that this market is unsecured. This is not the case for most end-users of these contracts. For example, on June 30, 2008, when Chesapeake owed about \$6.3 billion under our OTC derivative contracts, we had pledged collateral valued at more than \$11 billion to our derivative counterparties. The collateral we pledged included both letters of credit and mortgages on our oil and gas properties – our underlying business assets. While the security is not always in cash, our counterparties were and continue to be well-secured. This is how most end-users utilize this market and, as a result, help alleviate systemic risk.
- (3) Finally, there is a misconception that most OTC contracts are "standard" and can be easily housed on an exchange. However, an important feature of most OTC contracts is their ability to be "customized." Exchange-traded derivatives would not be able to be customized to offset our risks, therefore, the derivative would not precisely match the economics of the underlying risk being hedged. While OTC derivatives are not inherently complex products, their exact terms and conditions must be specifically customized to meet our needs, most importantly with respect to the accounting treatment governing our derivative contracts. Clearing requires standardization, and mandated clearing eliminates this essential ability to customize. Outside of the lack of economic offset, a standardized OTC contract would not meet stringent accounting rules, thus increasing near-term income statement volatility because of prudent longer-term risk-management policies. This "mis-match" could cause investors to be confused about financial results.

In short, as evidenced above, a company like Chesapeake Energy is merely an end-user of OTC derivatives. Companies like ours do not make the market, and we believe that forced

clearing ultimately will result in less end-user risk management and more volatility passed on to the consumer.

What We Support

There are important measures that Chesapeake supports. For instance, based on the proposals in your letter, we support the following initiatives and would be happy to discuss further:

- (1) First, **Chesapeake believes standardized trades between institutions (dealers, hedge funds, etc.) can be cleared**, addressing concerns about transparency and systemic risk without creating onerous, and at times unachievable, obstacles for end-users. We also believe determining what is "clearable" should be left to regulators, not clearinghouses.
- (2) Second, given concerns that the OTC derivatives market is uncollateralized or unsecured, **we recommend clear exceptions for clearing for end-users that protect their counterparties with ample and firm collateral**, such as – in our case – liens on our oil and natural gas properties.
- (3) We also support **counterparty reporting**, but not on a real-time basis, which is onerous and unnecessary to achieve the objectives of transparency. Additionally, we support reporting information to the general public on a regular basis.
- (4) Finally, **we support requirements to store all market information within a centralized warehouse** to facilitate access to information for regulators from a single source. Again, transparency and information-sharing are worthy goals, and we support both.

Thank you very much for your consideration, and we would be happy to expand further on any of the points in the letter and be a resource to you as a responsible end-user of OTC derivatives. Please contact Elliot Chambers at (405) 935-6119 or Sareh Gainer at (405) 935-4886 with any questions.

Best regards,


Jennifer Grigsby

CC:
The Honorable Harry Reid
The Honorable Nancy Pelosi
The Honorable Mitch McConnell
The Honorable John Boehner
The Honorable Christopher Dodd
The Honorable Tom Harkin
The Honorable Saxby Chambliss
The Honorable Barney Frank
The Honorable Spencer Bachus
The Honorable Collin Peterson
The Honorable Frank Lucas

The Role of Speculation in the Recent Commodity Price Boom (and Bust)

by

Scott H. Irwin, Dwight R. Sanders, and Robert P. Merrin*

Written testimony submitted to the Senate Committee on Agriculture, Nutrition and Forestry –
June 4, 2009

* Scott H. Irwin is the Laurence J. Norton Chair of Agricultural Marketing in the Department of Agricultural and Consumer Economics at the University of Illinois at Urbana-Champaign. Dwight R. Sanders is an Associate Professor in the Department of Agribusiness Economics at Southern Illinois University, Carbondale, Illinois. Robert P. Merrin is a Ph.D. student in the Department of Finance at Universiteit Maastricht, Netherlands.

The Role of Speculation in the Recent Commodity Price Boom (and Bust)

Introduction

Led by crude oil, commodity prices reached dizzying heights during mid-2008 and then subsequently declined with breathtaking speed (see Figure 1). The impact of speculation, principally by long-only index funds, on the boom and bust in commodity prices has been hotly debated.¹ It is commonly asserted that speculative buying by index funds in commodity futures and over-the-counter (OTC) derivatives markets created a "bubble," with the result that commodity prices, and crude oil prices, in particular, far exceeded fundamental values at the peak (e.g., Ghcit, 2008; Masters 2008; Masters and White, 2008). The main thrust of bubble arguments is that: i) a large amount of speculative money was invested in different types of commodity derivatives over the last several years, ii) this 'titanic' wave of money resulted in significant and unwarranted upward pressure on commodity prices, and iii) when the flow of speculative money reversed the bubble burst. Based on the bubble argument, a number of bills have been introduced in the U.S. Congress with the purpose of prohibiting or limiting index fund speculation in commodity futures and OTC derivative markets.

The purpose of this paper is to show that the bubble argument simply does not withstand close scrutiny. Four main points are explored. First, the arguments of bubble proponents are conceptually flawed and reflect fundamental and basic misunderstandings of how commodity futures markets actually work. Second, a number of facts about the current situation in commodity markets are inconsistent with the existence of a substantial bubble in commodity prices. Third, available statistical evidence does not indicate that positions for any group in commodity futures markets, including long-only index funds, consistently lead futures price

changes. Fourth, there is a historical pattern of attacks upon speculation during periods of extreme market volatility.

Conceptual Errors

As noted in the introduction, bubble proponents argue that large investment flows, through index-type investments, resulted in unjustified upward pressure on commodity prices. Not only was the pressure unjustified according to bubble proponents, but it also caused very large overvaluations of commodities. For example, Fadel Gheit, Managing Director and Senior Oil Analyst for Oppenheimer & Co. Inc., made the following statement while testifying before the U.S. House of Representatives in June 2008:

"I firmly believe that the current record oil price in excess of \$135 per barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above \$60 per barrel... There were no unexpected changes in industry fundamentals in the last 12 months, when crude oil prices were below \$65 per barrel. I cannot think of any reason that explains the run-up in crude oil price, beside excessive speculation." (Gheit, 2008).

While bubble arguments may seem sensible on the surface, they contain conceptual errors that reflect a fundamental and basic misunderstanding of how commodity futures and OTC derivative markets actually work.

The first and most fundamental error is to equate money flows into futures and derivatives markets with demand, at least as economists define the term. Investment dollars flowing into either the long or short side of futures or derivative markets is not the same thing as demand for physical commodities. Our esteemed predecessor at the University of Illinois, Tom Hieronymus, put it this way, "...for every long there is a short, for everyone who thinks the price is going up there is someone who thinks it is going down, and for everyone who trades with the flow of the market, there is someone trading against it." (Hieronymus, 1977, pp. 302) These are

zero-sum markets where all money flows must by definition net to zero. It makes as much logical sense to call the long positions of index funds new “demand” as it does to call the positions on the short side of the same contracts new “supply.”

An important and related point is that a very large number of futures and derivative contracts can be created at a given price level. In theory, there is no limit. This is another way of saying that flows of money, no matter how large, do not necessarily affect the futures price of a commodity at a given point in time. Prices will change if new information emerges that causes market participants to revise their estimates of physical supply and/or demand. Note that a contemporaneous correlation can exist between money flows (position changes) and price changes if information on fundamentals is changing at the same time. Simply observing that large investment has flowed into the long side of commodity futures markets at the same time that prices have risen substantially (or the reverse) does not necessarily prove anything. This is more than likely the classical statistical mistake of confusing correlation with causation. One needs a test that accounts for changes in money flow and fundamentals before a conclusion can be reached about the impact of speculation.

It should be said that the previous argument assumes all market participants are equally informed. When this is not the case, it is rational for participants to condition demands on both their own information and information about other participants’ demands that can be inferred (“inverted”) from the futures price (Grossman, 1986). The trades of uninformed participants can impact prices in this more complex model if informed traders mistakenly believe that trades by uninformed participants reflect valuable information. An argument along these lines can be applied to the rise of index funds in commodity markets. It is possible that traders interpreted the large order flow of index funds on the long side of the market as a reflection of valuable private

information about commodity price prospects, which would have had the effect of driving price higher as these traders subsequently revised their own demands upward. Given the publicity that accompanied index fund entry into commodity futures markets and the transparency of their trading methods, it is highly doubtful that this happened on a wide enough scale in recent years to consistently drive price movements (more on this in a later discussion of noise trading).

The second conceptual error is to argue that index fund investors artificially raise both futures and cash commodity prices when they only participate in futures and related derivatives markets. In the short-run, from minutes to a few days, commodity prices typically are discovered in futures markets and price changes are passed from futures to cash markets (e.g., Garbade and Silber, 1983). This is sensible because trading can be conducted more quickly and cheaply in futures compared to cash markets. However, longer-term equilibrium prices are ultimately determined in cash markets where buying and selling of physical commodities must reflect fundamental supply and demand forces. This is precisely why all commodity futures contracts have some type of delivery or cash settlement system to tie futures and cash market prices together. Of course, delivery systems do not always work as well as one would hope (Irwin et al., 2008).

It is crucial to understand that there is no change of ownership (title) of physical quantities until delivery occurs at or just before expiration of a commodity futures contract. These contracts are financial transactions that only rarely involve the actual delivery of physical commodities. In order to impact the equilibrium price of commodities in the cash market, index investors would have to take delivery and/or buy quantities in the cash market and hold these inventories off the market. There is absolutely no evidence of index fund investors taking delivery and owning stocks of commodities. Furthermore, the scale of this effort would have

had to be immense to manipulate a world-wide cash market as large as the crude oil market, and there simply is no evidence that index funds were engaged in the necessary cash market activities.

This discussion should make it clear that it is wrong to draw a parallel (e.g., Masters and White, 2008) between index fund positions and past efforts to “corner” commodity markets, such as the Hunt brother’s effort to manipulate the silver market in 1979-80. The Hunt brothers spent tens of millions of dollars buying silver in the cash market, as well as accumulating and financing huge positions in the silver futures market (Williams, 1995). All attempts at such corners eventually have to buy large, and usually increasing, quantities in the cash market. As Tom Hieronymus noted so colorfully, there is always a corpse (inventory) that has to be disposed of eventually. Since there is no evidence that index funds had any participation in the delivery process of commodity futures markets or the cash market in general, there is no obvious reason to expect their trading to have impacted equilibrium cash prices.

A third conceptual error made by many bubble proponents, and unfortunately, many other observers of futures and derivatives markets, is an unrealistic understanding of the trading activities of hedgers and speculators. In the standard story, hedgers are benign risk-avoiders and speculators are active risk-seekers. This ignores nearly a century of research by Holbrook Working, Roger Gray, Tom Hieronymus, Lester Telser, Anne Peck, and others, showing that the behavior of hedgers and speculators is actually better described as a continuum between pure risk avoidance and pure speculation. Nearly all commercial firms labeled as “hedgers” speculate on price direction and/or relative price movements, some frequently, others not as frequently. In the parlance of modern financial economics, this is described as hedgers “taking a view on the market” (e.g., Stulz, 1996). Apparently, there is also some contamination in the non-commercial

category, with "speculators" engaged in hedging activities. This problem is highlighted in the recent Commodity Futures Trading Commission (CFTC) report on swap dealers and index traders, which included the statement that, "The current data received by the CFTC classifies positions by entity (commercial versus noncommercial) and not by trading activity (speculation versus hedging). These trader classifications have grown less precise over time, as both groups may be engaging in hedging and speculative activity." (CFTC, 2008b, p. 2)

What all this means is that the entry of index funds into commodity futures markets did not disturb a sterile textbook equilibrium of pure risk-avoiding hedgers and pure risk-socking speculators, but instead the funds entered a dynamic and ever changing "game" between commercial firms and speculators with various motivations and strategies. Since large commercial firms can take advantage of information gleaned from their far-flung cash market operations, it is not unreasonable to expect that these firms have a trading advantage compared to all but a few very large speculators.² The following passage from a recent article on Cargill, Inc. (Davis, 2009) corroborates this view of the operation of commodity futures markets:

Wearing multiple hats gives Cargill an unusually detailed view of the industries it bets on, as well as the ability to trade on its knowledge in ways few others can match. Cargill freely acknowledges it strives to profit from that information. "When we do a good job of assimilating all those seemingly unrelated facts," says Greg Page, Cargill's chief executive, in a rare interview, "it provides us an opportunity to make money...without necessarily having to make directional trades, i.e., outguess the weather, outguess individual governments."

This sheds an entirely different light on the entry of large index fund speculators into commodity futures and derivatives markets. Large hedgers are no innocents in this game and their economic interests are not easily harmed by new entrants.

Inconsistent Facts

In addition to logical errors, a number of facts about the situation in commodity markets are inconsistent with the arguments of bubble proponents. To begin, if speculation drove futures prices consistently above fundamental values, the available data indicates it was not obvious in the relative level of speculation to hedging. The statistics on long-only index fund trading reported in the media and discussed at Congressional hearings tend to view speculation in a vacuum—focusing on absolute position size and activity. As first pointed out by Working (1960), an objective analysis of futures market activity must consider the balance between speculators and commercial firms hedging market risks. A key insight from this framework is that speculation can only be considered ‘excessive’ relative to the level of hedging activity in the market.³

Weekly Commitments of Traders (COT) data provided by the CFTC are enlightening in this regard. Table 1 shows the division of open interest for nine commodity futures markets, averaged for the first three months of 2006 and 2008.⁴ The four basic hedging and speculative positions are: HL = Hedging Long = Commercial Long Positions; HS = Hedging Short = Commercial Short Positions; SL = Speculation Long = Non-Commercial Long + Index Trader Long Positions; SS = Speculation Short = Non-Commercial Short + Index Trader Short Positions. Note that index fund traders are allocated almost exclusively to the SL category in Table 1 and that $HL + SL = HS + SS$.⁵

As expected, Table 1 reveals that long speculation—driven by index funds—increased sharply in all but one of the nine commodity futures markets over January 2006 through April 2008.⁶ In four of the eight markets with an increase in long speculation (corn, soybeans, soybean oil, and cotton), the increase in short hedging actually exceeded the increase in long

speculation. Corn provides a pertinent example. Speculative buying in corn, which includes commodity index funds for this analysis, increased by nearly 250,000 contracts; but, selling by commercial firms involved in the production and processing of corn increased by an even greater amount, around 500,000 contracts. What this means is that long speculators (as a group) must have been trading with short hedgers. Working (1960) argued that this was beneficial to overall market performance since speculators provide liquidity and risk-bearing capacity for hedgers.

In the other four markets with an increase in long speculation (CBOT wheat, live cattle, feeder cattle, and lean hogs), the increase in short hedging was less than the increase in long speculation. Live cattle provides a pertinent example here. Speculative buying in cattle, again including commodity index funds, increased by nearly 70,000 contracts; whereas selling by commercial firms increased by only about 16,000 contracts. In this situation the bulk of the increase in long speculation had to be absorbed by an increase in short speculation. Working (1960, p. 210) argued that trading between speculators generally was “unnecessary” and reflected either, “entry into the market of a considerable group of inexperienced or ill-informed speculators” or “recognition by one group of speculators of significant economic conditions or prospects that are currently being ignored by other, equally expert and generally well-informed, speculators.” Either case could result in a deterioration of market performance. However, Sanders, Irwin, and Merrin (2008a) show that the observed increase in speculation for these markets was still well within historical bounds for commodity futures markets. Even higher levels of speculation have been observed in the past without adverse consequences for market performance.

In sum, observed speculative levels in commodity futures markets since early 2006, even after accounting for index trader positions, either did not exceed the hedging needs of

commercial firms or did not exceed historical norms for the level of speculation relative to hedging needs. Simply put, there is no compelling evidence that speculation was ‘excessive.’

The second inconsistent fact is that price movements in futures markets with substantial index fund investment were not uniformly upward through the spring of 2008. Panel A in Table 2 shows the increase in commodity futures prices over January 2006—April 2008 for the same nine markets as in Table 1. The spectacular price increases were concentrated in grain and oilseed markets, while prices in other markets either increased moderately or declined. It is especially interesting to note that prices either dropped or rose only slightly in the markets with the highest level of speculation relative to hedging (Table 1: live cattle, feeder cattle, and lean hogs). Figure 2 reveals the same pattern in a different form. Here the position of commodity index traders over time is plotted as a percentage of total market open interest. The highest concentration of index fund positions was often in livestock markets, the very markets without large price increases through the spring of 2008. It is difficult to rationalize why index fund speculation would have little or no impact in commodity futures markets with the highest concentration of index positions, relative to either hedging positions or total open interest, yet have a large impact in the markets with the lowest concentration.

The third inconsistent fact is that high prices were also observed in commodity markets not connected to index fund investment. Panels B and C in Table 2 provide four examples.⁷ Rough rice futures and fluid milk futures are not included in popular commodity indices tracked by index funds, but prices in these two markets increased 162% and 37%, respectively, over January 2006—April 2008. Apples for fresh use and edible beans do not have futures markets, and thus no index fund investment, yet prices in these markets increased 58% and 78%, respectively, over the same time interval. If index fund speculation caused a bubble in

commodity prices, why then did prices increase substantially in commodity markets without any index fund activity?

A fourth inconsistent fact has to do with inventories for storable commodities. Following Krugman (2008), Figure 3 illustrates market equilibrium for a storable commodity with and without a price bubble. The standard equilibrium occurs at the intersection of the supply and demand curves and results in a price of P_E . Now assume there is a bubble in the market that pushes price above equilibrium to P_B . At this inflated price the quantity supplied exceeds quantity demanded and the excess shows up as a rise in inventories. We should therefore observe an increase in inventories when a bubble is present in storable commodity markets. In fact, inventories for corn, wheat, and soybeans fell sharply over the last three years. Inventories of other commodities, such as crude oil, stayed relatively flat or declined modestly until very recently. The lack of a notable buildup in commodity inventories is one more reason to be skeptical that a large bubble developed in commodity futures prices.

A fifth inconsistent fact is the nature of commodity index trading. The literature on "noise traders" shows that a group of uninformed traders can consistently push prices away from fundamental value only if their market opinions are unpredictable, with the unpredictability serving as a deterrent to arbitrage (e.g., De Long et al., 1990). This notion seems unlikely given the ease with which other large traders can trade against index fund positions. Index funds do not attempt to hide their current position or their next move. Generally, funds that track a popular commodity index (e.g., Goldman Sachs Commodity Index) publish their mechanical procedures for rolling to new contract months. Moreover, they usually indicate desired market weightings when the index is re-balanced. So, the main uncertainty in their trading patterns

usually stems from overall in-flow or out-flows of monies associated with the underlying investment vehicle.

The problems created by the mechanical trading of index funds is well-illustrated by a recent story (Meyer and Cui, 2009) on problems experienced by the U.S. Oil Fund L.P., the largest exchange-traded crude oil index fund, when rolling positions from one nearby contract to the next:

"It's like taking candy from a baby," said Nauman Barakat, senior vice president at Macquarie Futures USA in New York. That candy comes out of the returns of investors in the fund. Take Feb. 6, when U.S. Oil moved its 80,000 contracts from March to April at the end of the trading day, selling the March contract and buying April. Because U.S. Oil publishes the dates of its roll in advance, traders knew the switch was coming. At 2 p.m., 30 minutes before closing, trading in New York Mercantile Exchange oil contracts soared, and the price of the April contract narrowed to \$4 more than the March contract. Within minutes, that gap had widened and closed at \$5.98, according to trading records. As the fund's managers were about to roll their contracts, "suddenly came the awfully extreme move," said one manager. Some said the move is a sign that big trades were placed ahead of U.S. Oil's roll. The price move instantly made it more expensive for U.S. Oil to roll into the April contract and cost the fund about \$120 million more than it would have a day earlier."

As the above passage so amply highlights, it is highly unlikely that other well-capitalized speculators, such as commodity trading advisors, hedge funds, and large floor traders, would allow index funds to push futures prices away from fundamental values when index trades are so easily anticipated.

A related point is that large and long-lasting bubbles are less likely in markets where deviations from fundamental value can be readily arbitrated away (easily "poached" in the terminology of Patel, Zeckhauser, and Hendricks (1991)). There are few limitations to arbitrage in commodity futures markets because the cost of trading is relatively low, trades can be executed literally by the minute, and gains and losses are marked-to-the-market daily. Moreover, the finite horizon of futures contracts further diminishes the likelihood that speculative arbitrage

is limited (Shleifer and Summers, 1990). This stands in contrast to markets where arbitrage is more difficult, such as residential housing. The low likelihood of bubbles is also supported by numerous empirical studies on the efficiency of price discovery in commodity futures markets (e.g., Zulauf and Irwin, 1998). Where pricing problems have been documented, they are typically associated with the delivery period of particular commodity futures contracts. However, as noted by the CFTC in a recent background memorandum on the application of its emergency powers, even this type of problem has only risen to an “emergency” level three times since the Commission was founded in 1974 (CFTC, 2008a).

Empirical Tests

The preceding discussion focuses on empirical facts that are inconsistent with substantial bubbles in commodity futures prices. When considered as a whole, these facts build a persuasive case against bubbles. However, the facts are largely circumstantial, since they tend to rely on indirect evidence. Bubble proponents can then argue that “this time is different” even if the links between commodity money flows and bubbles are not fully understood. This is an especially difficult argument to settle because the one variable that can provide definitive evidence about the level of commodity prices—fundamental value—is unobservable. It is like politics, everyone has an opinion.

While fundamental value is unobservable, all is not lost. It is still possible to conduct empirical tests of the hypothesis that money flows from index funds aided and abetted the recent boom and bust in commodity prices. This can be done by running standard Granger causality tests between futures price changes and position changes in commodity futures markets. These tests establish whether lagged position changes help to forecast current futures price changes.⁸

Sanders, Boris, and Manfredo (2004), Bryant, Bessler, and Haigh (2006), Gorton, Hayashi, and Rouwenhorst (2007), and Sanders, Irwin, and Merrin (2008b) conduct Granger causality tests using publically available data on positions of commercial, non-commercial, and non-reporting trader groups from the weekly COT report published by the CFTC.⁹ A typical set of results, drawn from Sanders, Irwin, and Merrin (2008b), is presented in Table 3. A statistically significant relationship between the movement of commodity futures prices and measures of position change is found in only 5 out of 30 cases. In other words, position changes by COT trader groups helps forecast futures price movements in only 16% of the cases, hardly more than what one would expect based on pure randomness. And the evidence is even slimmer if results are limited to non-commercial traders (speculators).

The previously cited studies cast considerable doubt on the value of position changes for any group in consistently forecasting futures price movements. However, these studies also use publically-reported COT data, which is aggregated across all contracts and reported only on a weekly or monthly basis. This may limit the power of Granger causality tests because positions cannot be matched precisely to contract maturity months and positions cannot be tracked over daily intervals. Some have argued that if speculator positions do impact returns it is most likely over time horizons shorter than a week (Streeter and Tomck, 1992).

The Interagency Task Force on Commodity Markets led by the CFTC recently conducted thorough Granger causality tests for the crude oil futures market using non-public data on the daily positions of commercial and non-commercial traders (ITFCM, 2008). Daily price changes and position changes for commercial and non-commercial traders, as well as various sub-groups of traders, were examined over January 2003—June 2008. Consistent with the findings in other studies, there was no evidence that daily position changes by any of the trader sub-categories

systematically led crude oil futures price changes over the full sample period. This result held for all categories of speculators tracked by the CFTC: non-commercial traders in total, hedge funds, swap dealers, and non-commercial traders combined with swap dealers. At least in the crude oil futures markets, Granger causality test results are unaffected by the use of daily versus weekly data or position changes for sub-groups of traders. This bolsters the findings from other studies that did not have access to such detailed data on trader positions.

Bubble proponents can still point out that none of the above referenced studies tested specifically whether commodity index trader positions help to forecast price movements over the last several years. In forthcoming work, Aulerich and Irwin (2009) provide just this type of evidence for 12 commodity futures markets. They conduct Granger causality tests using non-public data from the CFTC on the daily positions of commodity index traders over January 2000 through July 2008. A unique feature of this study is that the authors were able to extend the series on commodity index positions back through the entire sample under study for each of the 12 markets. Aulerich and Irwin found only a few cases where index trader position changes helped to forecast price changes in commodity futures markets. When significance was found the size of the estimated price impact was small. These findings also held when the sample was broken into sub-periods.

While it is always possible to dither over the power of Granger causality tests or whether specifications adequately control for changing fundamentals, the evidence to date leads to a high degree of skepticism that positions for any group in commodity futures markets, including index traders, consistently forecast futures price changes (this will not be true for skilled individual traders within a group).

Lessons from History

A pervasive theme running through the history of U.S. futures markets is skepticism or out-and-out hostility towards speculators (Jacks, 2007).¹⁰ Rapidly increasing or decreasing commodity prices at various times over the last 125 years have been accompanied by assorted attempts to curtail speculation or control prices. For example, just after World War II, soaring grain futures prices, especially for wheat, attracted political attention. President Truman proclaimed that, "the cost of living in this country must not be a football to be kicked around by grain gamblers," and ordered the Commodity Exchange Authority (precursor to today's Commodity Futures Trading Commission) to require futures exchanges to raise margins to 33% on all speculative positions, a truly extraordinary level. In a statement that echoes those being made today, President Truman added, "If the grain exchanges refuse, the government may find it necessary to limit the amount of trading."¹¹

In the boldest move against speculators in U.S. commodity futures, trade in onion futures was banned by the U.S. Congress in 1958. The ban, actually still in place, was due to the widespread belief that speculative activity created excessive price variation (Working, 1963). Again, in language very similar to that heard today, a Congressional report stated that "speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce."¹²

The experience of the last time period with a comparable level of structural change in commodity markets, 1972-1975, is particularly instructive. U.S. and international commodity markets experienced a period of rapid price increases from 1972-1975, setting new all-time highs across a broad range of markets. These price increases were often blamed on speculative

behavior associated with the "...tremendous expansion of trading in futures in a wide range of commodities" (Cooper and Lawrence, 1975, p. 702).¹³ Following these price increases, public and political pressure to curb speculation resulted in a number of regulatory proposals and the upward adjustment of futures margin requirements (Hieronymus, 1977; Rainbolt, 1977; Tomek, 1985). These changes were accompanied by even more drastic measures—such as federal price controls and an embargo against soybean exports—aimed at lowering commodity price levels.

The actions used to reign in supposedly damaging speculation in the past run the gamut from requiring futures exchanges to raise margins to an outright ban on futures trading. The historical evidence is thin, at best, that measures to limit the impact of speculation had the desired effect on market prices. For instance, there is no historical evidence that directives to increase futures margins were effective at lowering overall price levels. The only consistently documented impact of the higher margin requirements is a decline in futures trading volume due to the increased cost of trading (Fishe and Goldberg, 1986; Peck and Hudge, 1987; Haradouvelis and Kim, 1996).

Finally, it is important to note the historical pattern of attacks upon speculation. Petzel (1981, p. 117) commented that, "In periods of rising prices (e.g., the early 1920s, the Korean War, inflation, and the 1970s) grain speculators have been accused of increasing the prices of agricultural commodities artificially. During the early 1930s when agricultural prices were low, grain speculators were accused of depressing prices." Market cycles seem to be accompanied by a predictable pattern of speculative complaints: when prices are exceptionally low, natural sellers in the market, such as farmers, complain that speculators are the problem and when prices are exceptionally high, natural buyers in the market – consumers and processors – complain about speculators. While his focus was a relatively obscure episode in the 1925 wheat market, the

conclusion reached by Petzel (1981, p. 126) applies with equal force today, "...it is all too easy after suffering an economic loss to look for the villain in the piece. In 1925 the public found its villains and conspirators in the large speculators."

Conclusions

There is little evidence that the recent boom and bust in commodity prices was driven by a speculative bubble. If speculation by long-only index funds did impact commodity futures prices, it is not evident in the empirical evidence available to date. Economic fundamentals, as usual, provide a better explanation for the movements in commodity prices. The main factors driving prices up in the energy markets included strong demand from China, India, and other developing nations, a leveling out of crude oil production, a decrease in the responsiveness of consumers to price increases, and U.S. monetary policy (Hamilton, 2008). In the grain markets, factors driving up prices also included demand growth from developing nations and U.S. monetary policy, as well as the diversion of row crops to bio-fuel production and weather-related production shortfalls (Trostle, 2008). The favorable demand factors were reversed in quick order due to the recent financial market meltdown and burgeoning world-wide recession, leading to large price drops across-the-board in commodity futures markets (Good and Irwin, 2008). The complex interplay between these factors and how they impact commodity prices is often difficult to grasp in real-time and speculators have historically provided a convenient scapegoat for frustration with rapidly rising and falling prices.¹⁴

Legislative proposals currently being considered may in fact curtail speculation—through reduced volume of trade—but the initiatives could severely compromise the ability of commodity markets to accommodate the needs of firms to manage price risks. In particular, limiting the participation of index fund investors would rob the markets of an important source

of liquidity and risk-bearing capacity at a time when both are in high demand. The net result is that commodity futures markets will become less efficient mechanisms for transferring risk from parties who don't want to bear it to those that do, creating added costs that ultimately get passed back to producers in the form of lower prices and back to consumers as higher prices.

The recent attacks on speculation in commodity markets harkens back to an earlier era. For most of the past 30 years a consensus seemed to have been reached among policy-makers that speculation played a valuable and important role in commodity futures markets. Writing in the 1970s, Tom Hieronymus had this to say about the matter:

“For many years the anti-futures trading arguments tended to prevail so that speculation was treated as a necessary evil that accompanied the desirable hedging process. During the last decade the balance appears to have shifted so that a favorable view is more widely held. It is doubtful that the favorable view is yet in the majority but it is generally held by students of futures markets and increasingly held by members of Congress and the CFTC.” (Hieronymus, 1977, p. 298)

Much to the surprise of agricultural economists, there is little doubt after the political uproar of the last year that a majority of the public still does not hold a favorable view of speculation. It is yet to be determined whether members of the U.S. Congress hold the same view and whether this portends a return to the anti-futures trading environment of an earlier era.

References

- Aulerich, N.M., and S.H. Irwin. "Direct Evidence on the Relationship between Daily Positions of Index Traders and Price Changes in Commodity Futures Markets." Paper to be presented at the NCCC-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management, St. Louis, Missouri, April 20-21, 2009.
- Bryant, H., D.A. Bessler, and M.S. Haigh. "Causality in Futures Markets." *Journal of Futures Markets*. 26(2006):1039-1057.
- Commodity Futures Trading Commission (CFTC). "CFTC Emergency Authority Background." Washington, D.C., 2008a. Available online:
<http://cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcemergencyauthoritybackgrou.pdf>.
- Commodity Futures Trading Commission (CFTC). "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations." Washington, D.C., 2008b. Available online:
<http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf>.
- Cooper, R.N., and R.Z. Lawrence. "The 1972-75 Commodity Boom." *Brookings Papers on Economic Activity* 3(1975):671-723.
- Davis, A. "Cargill's Inside View Helps It Buck Downturn." *The Wall Street Journal*, January 14, 2009. Available online:
http://online.wsj.com/article/SB123189501407679581.html?mod=rss_whats_news_us.
- De Long, J. B., A. Shleifer, L. H. Summers, and R. J. Waldmann. "Noise Trader Risk in Financial Markets." *Journal of Political Economy* 98(1990):703-738.

- Engelke, L., and J.C. Yuen. "Types of Commodity Investments." in *The Handbook of Commodity Investing*, F.J. Fabozzi, R. Fuss, and D. Kaiser eds., Hoboken, NJ: John Wiley and Sons, 2008, pp. 549-569.
- Fishe, R.P.H., and L.G. Goldberg. "The Effects of Margins on Trading in Futures Markets." *Journal of Futures Markets* 6(1986):261-271.
- Garbade, K.D., and W.L. Silber. "Price Movements and Price Discovery in Futures and Cash Markets." *Review of Economics and Statistics* 65(1983):289-287.
- Gheit, F. "Testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives." June 23, 2008. Available online: http://energycommerce.house.gov/crmtc_mtg/110-oi-hrg_062308.Gheit-testimony.pdf.
- Good, D., and S. Irvin. "Implications of Credit Market Problems for Crop Prices." Illinois Farm Economics Update 2008-03, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008. Available online: http://www.farmdoc.uiuc.edu/IFEU/IFEU_08_03/IFEU_08_03.pdf.
- Gorton, G.B., F. Hayashi, and K.G. Rouwenhorst. "The Fundamentals of Commodity Futures Returns." National Bureau of Economic Research (NBER) Working Paper No. 13249, July 2007.
- Grossman, S.J. "An Analysis of "Insider Trading" on Futures Markets." *Journal of Business* 59(1986): S129-S146
- Hamilton, J.D. *Time Series Analysis*. Princeton, NJ: Princeton University Press, 1994

- Hamilton, J.D. "Understanding Crude Oil Prices." Working Paper, Department of Economics, University of California-San Diego, 2008. Available online:
http://dss.ucsd.edu/~jhamilto/understand_oil.pdf.
- Hardouvelis, G.A., and D. Kim. "Price Volatility and Futures Margins." *Journal of Futures Markets* 16(1996):81-111.
- Hartzmark, M. L. "Returns to Individual Traders of Futures: Aggregate Results." *Journal of Political Economy* 95(1987):1292-1306.
- Hieronimus, T.A. *Economics of Futures Trading for Commercial and Personal Profit, Second Edition*. New York, NY: Commodity Research Bureau, 1977.
- Interagency Task Force on Commodity Markets (ITFCM). "Interim Report on Crude Oil." Washington D.C., 2008. Available online:
<http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf>.
- Irwin, S.H., P. Garcia, D.L. Good, and E.L. Kunda. "Recent Convergence Performance of CBOE Corn, Soybean, and Wheat Futures Contracts." *Choices*, 2nd Quarter, 23(2008):16-21.
Available online: <http://www.choicesmagazine.org/magazine/article.php?article=26>.
- Jacks, D.S. "Populists versus Theorists: Futures Markets and the Volatility of Prices." *Explorations in Economic History* 44(2007):342-362.
- Krugman, P. "More on Oil and Speculation." *New York Times*, May 13, 2008. Available online:
<http://krugman.blogs.nytimes.com/2008/05/13/more-on-oil-and-speculation/>.
- Labys, W.C., and H.C. Thomas. "Speculation, Hedging and Commodity Price Behavior: An International Comparison." *Applied Economics* 7(1975):287-301.

- Masters, M.W. "Testimony before the Committee on Homeland Security and Government Affairs, U.S. Senate." May 20, 2008. Available online:
http://hsgac.senate.gov/public/_files/052008Masters.pdf
- Masters, M.W., and A.K. White. "The Accidental Hunt Brothers: How Institutional Investors are Driving up Food and Energy Prices." 2008. Available online:
<http://accidentalthuntbrothers.com/>
- Meyer, G., and C. Cui. "U.S. Oil Fund Finds Itself at the Mercy of Traders." *The Wall Street Journal*, March 6, 2009. Available online:
<http://online.wsj.com/article/SB123629874701846317.html>
- Patel, J., R. Zeckhauser, and D. Hendricks. "The Rationality Struggle: Illustrations from Financial Markets." *American Economic Review* 81(1981):232-236.
- Peck, A.E. "Reflections of Hedging on Futures Markets." *Food Research Institute Studies* 17(1979-80):327-349.
- Peck, A.E., and C. Budge. "The Effects of Extraordinary Speculative Margins in the 1947-48 Grain Futures Markets." *Food Research Institute Studies* 20(1987):165-180.
- Petzel, T.E. "A New Look at Some Old Evidence: The Wheat Market Scandal of 1925." *Food Research Institute Studies* 18(1981):117-128.
- Rainbolt, J.V. "Regulating the Grain Gambler and His Successors." *Hofstra Law Review* 6(1977):1-25.
- Sanders, D.R., K. Boris, and M. Manfredo. "Hedgers, Funds, and Small Speculators in the Energy Futures Markets: An Analysis of the CFTC's Commitments of Traders Reports." *Energy Economics* 26(2004):425-445.

- Sanders, D.R., S.H. Irwin, and R.P. Merrin. "The Adequacy of Speculation in Agricultural Futures Markets: Too Much of a Good Thing?" Marketing and Outlook Research Report 2008-02, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008a. Available online:
http://www.farmdoc.uiuc.edu/marketing/morr/morr_08-02/morr_08-02.pdf.
- Sanders, D.R., S.H. Irwin, and R.P. Merrin. "Smart Money? The Forecasting Ability of CFTC Large Traders." Working Paper, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, 2008b. Available online:
<http://www.farmdoc.uiuc.edu/irwin/research/SmartMoneyCFTCTradersI.pdf>.
- Shleifer, A., and L.H. Summers. "The Noise Trader Approach to Finance." *Journal of Economic Perspectives* 4(1990):19-33.
- Stout, L.A. "Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives." *Duke Law Journal* 48(1999):701-786.
- Streeter, D. H., and W. G. Tomek. "Variability in Soybean Futures Prices: An Integrated Framework." *Journal of Futures Markets* 12(1992):705-728.
- Stulz, R. M. "Rethinking Risk Management." *Journal of Applied Corporate Finance* 9(1996):8-24.
- Tomck, W. G. "Margins on Futures Contracts: Their Economic Roles and Regulation." in *Futures Markets: Regulatory Issues*, A. E. Peck ed. Washington, D.C., American Enterprise Institute for Public Policy Research, 1985, pp. 143-209.

- Trostle, R. "Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices." Outlook Report No. WRS-0801. Economic Research Service, U.S. Department of Agriculture, May 2008. Available online: <http://www.ers.usda.gov/Publications/WRS0801/WRS0801.pdf>.
- Williams, J. *Manipulation on Trial: Economic Analysis and the Hunt Silver Case*. Cambridge, UK: Cambridge University Press, 1995.
- Working, H. "Speculation on Hedging Markets." *Food Research Institute Studies* 1(1960):185-220.
- Working, H. "Futures Markets Under Renewed Attack." *Food Research Institute Studies* 4(1963):13-24.
- Zulauf, C.R., and S.H. Irwin. "Market Efficiency and Marketing to Enhance Income of Crop Producers." *Review of Agricultural Economics* 20(1998):308-331.

Endnotes

¹ In reality, a variety of investment instruments are lumped under the heading "commodity index fund." Individuals may enter directly into over-the-counter (OTC) contracts with swap dealers to gain the desired exposure to returns from a particular index of commodity prices. Some firms also offer investment funds whose returns are tied to a commodity index. Exchange-traded funds (ETFs) and structured notes (ETNs) have also recently been developed to make it even easier to gain commodity exposure. ETFs and ETNs trade on securities exchanges in the same manner as stocks on individual companies. See Engelke and Yuen (2008) and CFTC (2008b) for further details.

² Hieronymus (1977) argued that large commercial firms dominated commodity futures markets and speculators tended to be at a disadvantage. Based on his theoretical analysis, Grossman (1986, p. S140) asserted, "...it should come as no surprise if a study of trading profit finds that traders representing large firms involved in the spot commodity (i.e., commercial traders) make large trading profits on futures markets." In the classic empirical study on this subject, Hartzmark (1987) showed that large commercial firms in six of seven futures markets make substantial profits on their futures trades.

³ Peck (1979-80, p. 339) provides a succinct re-statement of Working's argument, "Taken together, these analyses reaffirm the fundamental importance of hedging to futures markets and dependence of total activity upon hedging needs. The results also lend support to the Working definition of an appropriate measure of hedger demands upon a market. Net hedging is not the most useful view of the demands commercial users make on a market. Speculation is needed to offset both long hedging and short hedging. Only coincidentally are long and short hedgers

sufficiently alike in date and amount to be offsetting, although increased balance increases the probability of such correspondence and differences in seasonal needs between long and short hedgers decreases this probability. The appropriate measure of minimum required speculation must at least begin with total hedging demand.”

⁴ Note that total open interest consists of futures open interest and delta-adjusted options open interest.

⁵ Non-reporting trader positions are allocated to the commercial, non-commercial, and index trader categories in the same proportion as that which is observed for reporting traders (see Sanders, Irwin, and Merrin, 2008a).

⁶ There is an important omission from Table 1—crude oil futures. As the CFTC noted when it first began publishing data on index fund positions, it is difficult to separate out index fund transactions in energy markets because of the degree to which many firms in these markets engage in multiple trading activities that fall into different classifications and the degree to which firms engage in internal netting of these activities. The special swap dealer survey (CFTC, 2008b) does provide an estimate of index trader positions in the crude oil futures market; however, the data are limited to a six-month period from December 31, 2007 to June 30, 2008 and reported only on a net long basis. Computations for crude oil that parallel those reported in Table 1 can be made only by assuming that short positions for index funds are zero.

⁷ The four markets were not selected at random, but instead represent markets that generally have low-cross price elasticities relative to the nine markets in Panel A. If the selected markets had high cross-price elasticities, then observed price increases could have been due to linkages with

the markets in Panel A (and possibly bubble effects in these markets) rather than fundamental factors specific to the selected markets or fundamental factors common to all the markets.

⁸ Granger causality tests reflect the basic idea that if event X causes event Y , then event X should precede event Y in time. These tests require careful interpretation if the null hypothesis of no causality (no statistical prediction) is rejected (Hamilton, 1994). A statistical correlation may be observed between X and Y when in reality an omitted variable Z is the true cause of both X and Y . Hamilton (1994, p. 308) suggests it is better to describe “Granger causality” tests between X and Y as tests of whether X helps forecast Y rather than whether X causes Y . He notes that the tests may have implications for causality in the conventional sense, but only in conjunction with other assumptions.

⁹ In a work well ahead of its time, Petzel (1981) conducted Granger causality tests between the daily position changes of three groups of speculators and price changes for the May 1925 wheat futures contract at the Chicago Board of Trade. Foreshadowing later results, he did not find any evidence that lagged position changes helped to forecast current price changes.

¹⁰ See Stout (1999) for an in-depth discussion of the legal and regulatory history of opposition to speculation in the U.S.

¹¹ Quoted in Peck and Budge (1987, p. 172).

¹² Quoted in Working (1963, p.18).

¹³ It is fascinating to observe the similarity of the current public debate about speculation and the one that followed the mid-70s commodity boom. For instance, Labys and Thomas (1975, p. 287) motivate their paper with words that could have been written in 2008 instead of 1975, “This paper analyses the instability of primary commodity prices during the recent period of economic

upheaval, and determines the extent to which this instability was amplified by the substantial increase in futures speculation which also occurred. Of particular interest is the degree to which this speculation rose and fell with the switch of speculative funds away from traditional asset placements and towards commodity futures contracts.”

¹⁴ The origin of the word “scapegoat” is of more than passing interest in the present context. In ancient Israel, the high priest confessed all the sins of the children of Israel on the Day of Atonement over the head of a live goat. As a symbol of their sins, the goat was then sent into the wilderness to perish.

Table 1. Speculative and Hedging Positions (number of contracts) in Agricultural Futures Markets, First Quarter of 2006 and 2008

| Market | | HL | HS | SL | SS |
|---------------|--------|---------|-----------|---------|---------|
| Corn | | | | | |
| | 2006 | 328,362 | 654,461 | 558,600 | 208,043 |
| | 2008 | 598,790 | 1,179,932 | 792,368 | 182,291 |
| | Change | 270,428 | 525,471 | 233,768 | -25,752 |
| Soybeans | | | | | |
| | 2006 | 126,832 | 192,218 | 183,105 | 107,221 |
| | 2008 | 175,973 | 440,793 | 351,379 | 74,844 |
| | Change | 49,141 | 248,575 | 168,274 | -32,377 |
| Soybean Oil | | | | | |
| | 2006 | 66,636 | 124,134 | 92,515 | 35,599 |
| | 2008 | 121,196 | 228,515 | 128,546 | 25,844 |
| | Change | 54,560 | 104,381 | 36,032 | -9,755 |
| CBOT Wheat | | | | | |
| | 2006 | 57,942 | 213,278 | 251,926 | 92,148 |
| | 2008 | 70,084 | 240,864 | 300,880 | 121,578 |
| | Change | 12,141 | 27,585 | 48,954 | 29,430 |
| KCBT Wheat | | | | | |
| | 2006 | 43,993 | 110,601 | 80,158 | 13,560 |
| | 2008 | 46,459 | 96,556 | 67,827 | 15,767 |
| | Change | 2,466 | -14,045 | -12,330 | 2,207 |
| Cotton | | | | | |
| | 2006 | 41,582 | 108,085 | 86,777 | 21,824 |
| | 2008 | 107,826 | 296,434 | 200,773 | 18,918 |
| | Change | 66,244 | 188,349 | 113,995 | -2,906 |
| Live Cattle | | | | | |
| | 2006 | 54,549 | 128,951 | 129,786 | 45,305 |
| | 2008 | 34,970 | 144,549 | 198,211 | 80,303 |
| | Change | -19,579 | 15,599 | 68,425 | 34,998 |
| Feeder Cattle | | | | | |
| | 2006 | 10,707 | 17,725 | 20,769 | 10,632 |
| | 2008 | 6,310 | 13,435 | 28,284 | 18,111 |
| | Change | -4,397 | -4,290 | 7,515 | 7,479 |
| Lean Hogs | | | | | |
| | 2006 | 15,949 | 65,438 | 93,522 | 40,036 |
| | 2008 | 36,825 | 113,971 | 149,415 | 69,055 |
| | Change | 20,876 | 48,533 | 55,893 | 29,019 |

Notes: HL = Hedging, Long; HS = Hedging, Short; SL = Speculating, Long; SS = Speculating, Short. The data reflect average positions in the first calendar quarter of 2006 and 2008, respectively. Open interest is aggregated across futures and options, with options open interest delta-adjusted to a futures equivalent basis.

Source: Sanders, Irwin, and Mccrin (2008a)

Table 2. Change in Commodity Prices, January 3, 2006—April 15, 2008

| Commodity | January 2006 | April 2008 | Change |
|---|---------------|---------------|--------|
| Panel A. Futures Markets Included in Popular Indexes | | | |
| Corn | \$2.20/bu. | \$6.06/bu. | 175% |
| Soybeans | \$6.28/bu. | \$13.80/bu. | 120% |
| Soybean Oil | 22.96¢/lb. | 62.52¢/lb. | 172% |
| CBOT Wheat | \$3.46/bu. | \$8.96/bu. | 159% |
| KCBOT Wheat | \$3.90/bu. | \$9.50/bu. | 136% |
| Cotton | 55.24¢/lb. | 75.23¢/lb. | 36% |
| Live Cattle | \$96.37/cwt. | \$91.57/cwt. | -5% |
| Feeder Cattle | \$114.00/cwt. | \$103.95/cwt. | -9% |
| Lean Hogs | \$64.65/cwt. | \$71.65/cwt. | 11% |
| Panel B. Futures Markets not Included in Popular Indexes | | | |
| Rough Rice | \$8.27/lb. | \$22.17/lb. | 168% |
| Fluid Milk | \$12.65/cwt. | \$17.29/cwt. | 37% |
| Panel C. No Futures Markets | | | |
| Apples Fresh Use | \$0.26/lb. | \$0.41/lb. | 58% |
| Edible Beans | \$19.30/cwt. | \$34.40/cwt. | 78% |

Notes: All prices refer to the relevant nearby futures price except apples and edible beans, which are monthly prices received by farmers.

Table 3. Granger Causality Test Results for CFTC Trader Categories, Positions Do Not Lead Returns, 1995-2006.

$$R_t = \alpha_t + \sum_{i=1}^n \gamma_i R_{t-i} + \sum_{j=1}^n \beta_j PNL_{t-j} + \varepsilon_t$$

| Market | P-values for Hypothesis Test: $\beta_j=0, \forall j$ | | |
|---------------|--|-----------------|---------------|
| | Commercials | Non-Commercials | Non-Reporting |
| Wheat CBOF | 0.01 | 0.18 | 0.54 |
| Wheat KCBOT | 0.03 | 0.24 | 0.71 |
| Wheat MGE | 0.63 | 0.15 | 0.76 |
| Corn | 0.35 | 0.79 | 0.33 |
| Soybeans | 0.83 | 0.05 | 0.78 |
| Soybean Oil | 0.24 | 0.30 | 0.94 |
| Soybean Meal | 0.70 | 0.93 | 0.61 |
| Lean Hogs | 0.05 | 0.34 | 0.08 |
| Live Cattle | 0.75 | 0.83 | 0.48 |
| Feeder Cattle | 0.10 | 0.16 | 0.23 |

Notes: R is the weekly return for nearby futures in the given market and PNL is the net long position of the trader group in percentage terms.

Source: Sanders, Irwin, and Merrin (2008b)

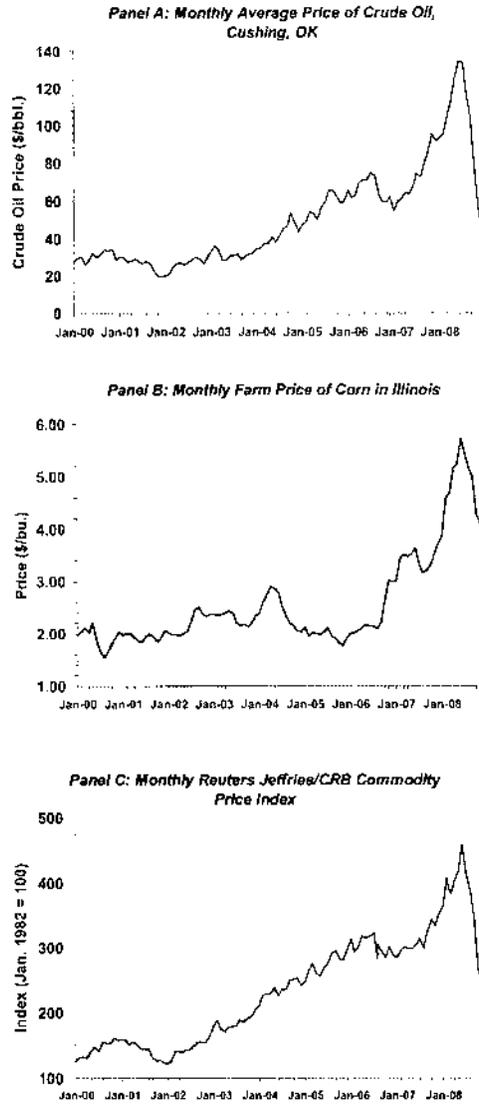
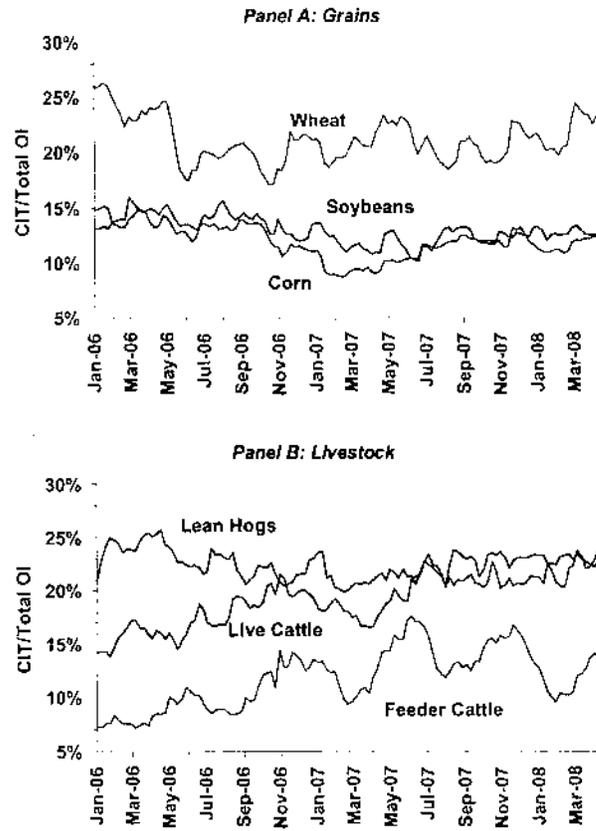


Figure 1. Selected Examples of the Movement of Monthly Commodity Prices, January 2000—December 2008



Note: Total open interest is aggregated across futures and options markets, with options open interest delta-adjusted to a futures equivalent basis.

Source: Sanders, Irwin, and Merrin (2008a)

Figure 2. Proportion of Open Interest Held by Commodity Index Traders (CITs) in Grain and Livestock Futures Markets, January 2006—June 2008

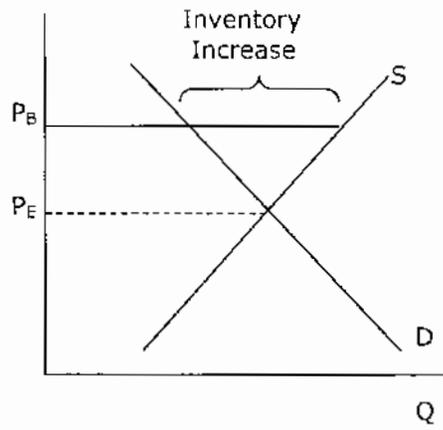


Figure 3. Theoretical Impact of a Price Bubble in a Storable Commodity Market



June 11, 2009

Committee on Agriculture, Nutrition and Forestry
 United States Senate
 328A Russell Senate Office Building
 Washington, DC 20510

Dear Chairman Harkin and Ranking Member Chambliss:

The Association for Financial Professionals (AFP) applauds the Chairman and Ranking Member of the Senate Committee on Agriculture, Nutrition, and Forestry for convening a thought-provoking hearing on the critical issue of regulations pertaining to derivative products. As the global daily resource and advocate for over 16,000 finance and treasury professionals in the United States, AFP maintains that derivative products are essential risk management tools that financial professionals rely on to help stabilize prices and mitigate risk. Our members support the enactment of legislation that encourages secure and transparent markets. However, AFP members have expressed concerns about the unintended consequences of proposals that require mandatory clearing of derivatives and futures products. We are concerned that regulations mandating the clearing of derivatives might negatively impact members' ability to enter into custom interest rate and foreign currency exchange swaps.

AFP members manage and safeguard the financial assets of more than 5,000 U.S. organizations. Our members are responsible for issuing short- and long-term debt and for managing corporate cash, 401(k) plans, and pension assets of their organizations. Many AFP members use interest rate and foreign exchange swaps in their daily business to mitigate risk for their organizations. We are concerned that inflexible regulation of the over-the-counter (OTC) derivatives market might negatively impact the sound and prudent practices of interest rate, foreign exchange swaps and ultimately make it impractical to use these products.

Specifically, many of AFP's financial accounting professionals have voiced concern over the possible conflicts between derivatives regulation, which may lead to the standardized contracts, and the strict hedge accounting rules imposed by the Financial Accounting Standard Board. Financial Accounting Standard 133 (FAS 133) requires a strict demonstration of the effectiveness of a given hedge, which would be impossible if customized contracts became prohibitively expensive or unavailable. With standardization, the ability to comply with the requirements of FAS 133 for applying hedge accounting treatment to swap transactions would become difficult, if not impossible. The net result of this change would be less hedging and more risks being borne by companies in an environment already marked by significant volatility.

Derivatives legislation is of great interest to AFP members for a variety of reasons important to the profession. Recently, AFP surveyed our members to assess the integration of risk management practices within their corporate culture and governance framework. Of all of the instruments used to manage financial risk, our research indicates that the vast majority of companies use over-the-counter forwards and swaps to mitigate that risk. 68% of the companies surveyed use interest rate swaps and 77% of the companies use foreign exchange swaps.

We also asked how the regulation of certain swap agreements would impact their use. In one example, a large health care company revealed that it relies on the ability to swap interest rates from floating to fixed in order to hedge interest rate risk. According to a senior treasury professional, if done correctly, "one can achieve hedge accounting treatment and all changes due to interest rate volatility will run through the balance sheet rather than income statement. This takes volatility out of the income statement and presumably out of the share price."

Another example revealed that a utility company uses swap agreements to hedge its expected future energy usage. A senior treasury executive shared that the company may purchase a contract to lock in the price of its future energy purchases. Under the short cut method, FAS 133 requires them to exactly match the terms and the dates of delivery and, if they do not match, the hedge is rendered ineffective, from an accounting perspective. Simply stated, if any aspect of

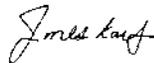
AFP Comments on Regulation of the OTC Derivatives Market
June 11, 2009
Page 2 of 2

the contract varies from the future purchase of energy, that variance would have to be reported on the income statement, which could cause significant volatility in the earnings of the company.

AFP applauds the efforts of the Senate Agriculture, Nutrition and Forestry Committee to bring transparency and stability to the OTC derivatives market, prevent excessive speculation, and secure derivatives markets. Our membership, experts on financial risk management for businesses across the United States, need interest rate swaps and foreign exchange swaps as essential tools for prudent risk management. Common practices already have banks playing a role similar to that of a clearinghouse, making these safe and secure transactions. As the Committee considers legislation on this issue we urge you to ensure that safeguards against abuse in the derivatives markets do not come at the cost of proven risk management tools that are critical to the stability of American businesses.

We thank the Committee and its members for its hard work and consideration of AFP's views on this matter. Please do not hesitate to contact AFP's Director of Finance Practice, Brian Kalish, at 301.961.6564 or bkalish@afponline.org, if you have further questions on AFP or our members' practices.

Sincerely,



James A. Kailz
President and CEO
Association for Financial Professionals

Cc: The Honorable Harry Reid, Senate Majority Leader
The Honorable Mitch McConnell, Senate Republican Leader
Members of the Senate Banking, Housing, and Urban Affairs Committee



COMMODITY MARKETS OVERSIGHT COALITION

June 3, 2009

The Honorable Nancy Pelosi
Speaker of the House
U.S. House of Representatives
H-212 Capitol Building
Washington, DC 20515

The Honorable John Boehner
Minority Leader
U.S. House of Representatives
H-204 Capitol Building
Washington, DC 20515

The Honorable Harry Reid
Majority Leader
United States Senate
S-221 Capitol Building
Washington, DC 20510

The Honorable Mitch McConnell
Minority Leader
United States Senate
S-230 Capitol Building
Washington, DC 20510

Dear Congressional Leaders:

Members of this coalition remain concerned that inadequate oversight of the commodities markets and excessive speculation will continue to erode public confidence in the ability of these markets to establish fair prices for energy, agricultural products and other commodities that are reflective of market fundamentals. We urge Congress to act decisively to bring full transparency to all trading environments and platforms, to prevent excessive speculation, and to close the door to potential manipulation.

2008 saw the most dramatic rise in commodities prices in history, resulting in inflated costs for energy and consumer goods in the United States. Internationally, millions of people were suddenly unable to feed themselves due to rising food commodity costs. Congressional hearings and reports revealed that inadequate or non-existent oversight of off-shore and over-the-counter (OTC) markets, ineffective oversight of on-exchange participants and activity, and an under-funded and under-staffed Commodity Futures Trading Commission (CFTC) had opened-the-door to excessive speculation and opaque trading activity. Additionally, members of this coalition voiced growing concern that passively-managed index funds, exchange-traded funds and actively traded hedge funds, swaps and derivatives were turning our commodity markets into a highly volatile "asset class."

We again urge the Congress to pass strong new legislation to restore our confidence in these markets as a risk management and price discovery tool for bona-fide commercial players.

Congress has taken some positive steps in the right direction, including last year's CFTC Reauthorization Act, which returns to the CFTC some authority over exempt commercial markets it had lost under the "Euron Loophole" in 2000. Appropriators have steadily increased CFTC funding levels in recent years to allow for much-needed staff, resources, and technology investments and we commend the President's FY2010 budget request of \$161 million. We commend the Senate for swift consideration of CFTC nominees, including the recently-confirmed Chairman Gary Gensler. We are also pleased that on May 13, 2009, President Obama announced his support for full transparency, accountability and oversight in the OTC markets.

Page 1 of 4

Commodity Markets Oversight Coalition
LETTER TO CONGRESSIONAL LEADERS
June 8, 2009

Coalition Contact
Jim Colura, New England Fuel Institute
jmcultura@nefi.com or (202) 594-0100

But absent strong and sweeping reform, we will continue to witness extreme price volatility and excessive speculation. Trading will continue to grow in "dark" or unregulated markets and investment speculators will continue to elude federal oversight, data reporting requirements and position limits. Families, businesses, farmers and laborers at home and abroad will continue to "pay the price" in many ways, including volatile and unpredictable energy, food and raw materials prices; impeding economic growth, development, investment, and job creation.

Therefore, we urge Congress to work swiftly and approve legislation that will:

- Address market activity for *all* commodities, including energy, agriculture, livestock and metals;
- Fully close the "Enron Loophole" by requiring that large over-the-counter trades comply with data reporting requirements and are made subject to speculative position limits;
- Close the so-called "Foreign Markets Loophole" or "London Loophole" by requiring the presence of foreign regulators with comparable oversight in order for an off-shore exchange to obtain regulatory exemptions (i.e., no-action letters);
- Close the "Swaps Loophole" by limiting hedging exemptions to *bona-fide* commercial participants and requiring that swap traders, index funds and institutional investors comply with all CFTC speculation limits and data reporting requirements;
- Limit exchange traded fund investments in physical commodities and their derivatives;
- Require across-the-board aggregate speculation limits to prevent traders from taking a controlling position in a commodity by taking large positions on multiple platforms;
- Require the CFTC to review all current regulatory exemptions and require Commissioners to withdraw them as appropriate or in accordance with existing or new authorities granted by Congress;
- Require a thorough review of all new and existing rules and regulations designed to protect market users and the public from fraud, manipulation and excessive speculation, including position limits, margin requirements, data reporting requirements, and public availability of data; and
- Require a thorough review of emerging environmental markets, emissions trading and related Wall Street products and instruments, including derivatives, index funds and exchange traded funds.

The ability to determine a fair price for commodities based on market fundamentals is vital to the success of recent efforts to address energy security, climate change, and the needs of the poor, low income and unemployed. It is essential to the welfare of farmers, truckers, laborers and small businesses, to new job growth and to the overall recovery of an economy that has been wounded by insufficient transparency and oversight of the financial services industry.

In recent weeks, energy commodities including natural gas, crude oil and refined petroleum products have been trading substantially higher despite record inventories and low demand. Internationally, some predict a tight food commodity market in the year ahead. According to a recent Barclays Capital survey, 79 percent of investors plan to increase holdings in these markets. Congress must do its part to help prevent another speculator-driven run-up in energy, agriculture, and other vital commodities.

Commodity Markets Oversight Coalition
 Letter to Congressional Leaders
 June 3, 2009

Coalition Contact:
 Jim Cellura, New England Fuel Institute
 jimcellura@neffi.com or (202) 584-0160

In both chambers of Congress, several bills have been introduced to address the issues discussed in this letter. It is our hope that members can work out their differences and, working with members of this coalition, move forward to pass strong and comprehensive legislation, put an end to excessive speculation and "dark market" trading, and restore confidence in our commodity markets.

Thank you for your consideration.

Sincerely,

Agricultural Missions, Inc.
 Agricultural Retailers Association
 Air Transport Association
 American Association of Crop Insurers
 American Cotton Exporters Association
 American Cotton Shippers Association
 American Public Gas Association
 American Trucking Associations
 Arkansas Oil Marketers Association
 Atlantic Cotton Association
 California Black Farmers and Agriculturalists Association
 Caney Fork Headwaters Association
 Colorado Wyoming Petroleum Marketers Association
 Columban Center for Advocacy and Outreach
 Congregation of Holy Cross
 Consumer Federation of America
 Consumer Watchdog
 Cumberland Countians for Peace & Justice
 Family Farm Defenders
 Florida Petroleum Marketers and Convenience Store Association
 Food & Water Watch
 Friends of the Earth US
 Fuel Merchants Association of New Jersey
 Gasoline & Automotive Service Dealer's of America
 Grassroots International
 Holy Cross International Justice Office
 Illinois Association of Convenience Stores
 Illinois Petroleum Marketers Association
 Industrial Energy Consumers of America
 Independent Oil Marketers Association of New England
 Institute for Agriculture and Trade Policy
 Justice and Witness Ministries, United Church of Christ
 Louisiana Oil Marketers & Convenience Store Assn.
 Maine Oil Dealers Association
 Mayknoll Office for Global Concerns
 Massachusetts Oilheat Council
 Mid-Atlantic Petroleum Distributors Association
 Missionary Society of St. Columban

Page 3 of 4

Commodity Markets Oversight Coalition
 Letter to Congressional Leaders
 June 9, 2009

Coalition Contact:
 Jim Colburn, New England Fuel Institute
 jim.colburn@nefi.com or (603) 594-0100

Montana Petroleum Marketers Association
 National Association of Convenience Stores
 National Association of Oil Heat Service Managers
 National Association of Truck Stop Operators
 National Catholic Rural Life Conference
 National Family Farm Coalition
 National Farmers Union
 National Latino Farmers & Ranchers Trade Association
 Nebraska Petroleum Marketers & Convenience Store Association
 Network for Environmental & Economic Responsibility, United Church of Christ
 New England Fuel Institute
 New Jersey Citizen Action Oil Group
 New Mexico Petroleum Marketers Association
 New Rules for Global Finance
 New York Oil Heating Association
 Ohio Petroleum Marketers & Convenience Store Association
 Oil Heat Council of New Hampshire
 Oil Heat Institute of Long Island
 Oil Heat Institute of Rhode Island
 Petroleum Marketers Association of America
 Petroleum and Convenience Marketers of Alabama
 Petroleum Marketers and Convenience Store Association of Kansas
 Petroleum Marketers and Convenience Stores of Iowa
 Platform ABC (Earth, Farmer, Consumer), Netherlands
 Public Citizen
 Quixote Center
 Ranchers-Cattlemen Legal Action Fund / ReCALF USA
 Rural Coalition/Coalición Rural
 Sisters of the Holy Cross Congregation Justice Committee
 Sisters of Notre Dame de Namur Justice and Peace Network
 Society of Independent Gasoline Marketers of America
 Southern Cotton Association
 Texas Cotton Association
 United Egg Association
 United Egg Producers
 Utah Petroleum Marketers and Retailers Association
 Vermont Fuel Dealers Association
 West Virginia Oil Marketers and Grocers Association
 Western Cotton Shippers Association
 Western Peanut Growers Association
 Wisconsin Crop Production Association
 World Cotton Exporters Association

cc: All members of the United States House of Representatives and the United States Senate
 The Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission
 The Honorable Michael Dunn, Commissioner, Commodity Futures Trading Commission
 The Honorable Walter Lukken, Commissioner, Commodity Futures Trading Commission
 The Honorable Jill E. Sommers, Commissioner, Commodity Futures Trading Commission
 The Honorable Bart Chilton, Commissioner, Commodity Futures Trading Commission

Page 4 of 4



Jay Timmons
Executive Vice President

June 3, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

The National Association of Manufacturers (NAM), the nation's largest industrial trade association, appreciates and supports the Administration's efforts to improve transparency, accountability and stability in the derivatives market. At the same time, we have some concerns about the proposed regulatory framework for over-the-counter (OTC) derivatives, released by the Treasury Department on May 13, 2009.

Manufacturers of all sizes use OTC derivatives to manage the cost of borrowing or other risks of operating their businesses, including fluctuating currency exchange, interest rates and commodity prices. The ability of commercial users to continue to use OTC derivatives is critical for mitigating risk and limiting damage to the balance sheets of American businesses, particularly during these unprecedented market conditions.

While we support initiatives to prevent excessive speculation and improve transparency and stability in the derivatives market, it is critical that policy makers preserve the ability of responsible companies to access critical OTC derivative products. Consequently, we are concerned about the following issues in the Treasury proposal:

- **Standardization:** A key benefit of OTC derivatives to commercial users is the ability of companies to customize derivatives to their specific risk management needs. Provisions that require the clearing of OTC derivatives would lead to the standardization of these tools, impeding the ability of companies to accurately hedge risks and comply with the requirements of Financial Accounting Standard 133 (FAS 133). Without the ability to hedge specific risks, companies would be forced to shoulder greater risks in an environment already marked by high volatility.
- **Cost of "Clearing":** Exchanges insulate commercial participants from credit exposure by requiring the value of the derivative contract (mark to market) to be posted in cash or Treasury securities and for market moves twice a day. The efficiency of clearing relies on high volumes of standardized products, characteristics that do not exist in the individual hedging transactions of the OTC market. Hedging in the OTC market is customized to fit the actual underlying risk on the value of the goods shipped and produced. The margin requirements associated with clearing would create an additional

Manufacturing Makes America Strong

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790 • (202) 637-3043 • Fax (202) 637-3182 • jtimmons@nam.org • www.nam.org

The Honorable Timothy F. Geithner
June 3, 2009
Page Two

administrative and liquidity burden for commercial users, resulting in additional financing and administrative costs.

- **Limited Dealers:** NAM members also are concerned about the potentially unintended consequence of reduced competition in the provision of OTC commodity derivative products, which would have a negative impact on end users. Any reform proposal should not create a monopoly in the OTC derivatives market for a certain group of dealers at the expense of the manufacturers who need to manage their risk. This would only increase prices, reduce transparency, and increase systemic risk.

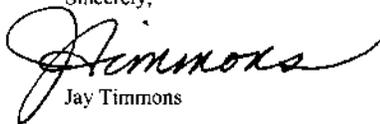
On a broader note, the NAM agrees with the Administration that the current financial crisis has exposed some areas in our financial regulatory system that should be addressed. Not all OTC derivatives, however, pose a risk to the financial system. We welcome the opportunity to work with policy makers to identify where increased, targeted oversight is warranted.

Similarly, while we understand the need for adequate reporting and record keeping, corporations already provide reports to the Securities and Exchange Commission (SEC) and other government agencies. We would like to work with policy makers on ways to set up a trade repository to enhance further transparency by pulling together information already required under existing reporting requirements.

In sum, NAM members believe strongly that any reform effort should ensure companies' continued access to OTC derivatives, providing them with greater financial certainty and allowing them to allocate resources to core business activities. Thank you in advance for considering our concerns. As this proposal moves through the legislative process, we look forward to working with you and members of Congress on legislation that encourages transparency and stability in the derivatives markets without sacrificing the ability of corporations to use these necessary tools.

With all best wishes, I remain,

Sincerely,



Jay Timmons

JT/gjj

QUESTIONS AND ANSWERS

JUNE 4, 2009

Chambliss for Chairman Gensler

1. You state in your testimony that swap dealers should be required to post capital and be subject to margin requirements. In his written testimony, Mr. Dines from Cargill states that "there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers." He goes on to discuss the inappropriateness of eliminating non-financial institutions as competitors. Do you feel that the regulatory regime you have outlined today for the regulation of dealers would in fact result in only financial institutions remaining as sell-side swap participants?
2. What information would CFTC find useful in a mandatory reporting regime? Would mandatory reporting for all transactions create more information than would be useful for regulatory analytical purposes? How would you structure mandatory reporting? Does the CFTC have the resources to analyze such a vast amount of data? Who do you feel should regulate the trade repositories you mention in your testimony, and do you envision one entity taking on this responsibility for all OTC transactions?
3. I gather from your testimony that you and I agree that the need for customized transactions requires us to find a way to make sure businesses can still use these vital risk management tools under this new regulatory regime. In your testimony, as Secretary Geithner did in his letter to the Congress last month, you state that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing. Do you feel that the clearinghouses are the most appropriate entity to determine if a contract is standardized?
4. You have proposed product standardization so that "OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another." Are you proposing that the best capitalized clearing houses with the strongest creditworthiness be forced to accept the credit and risk of dealing with potentially weaker clearing houses?
5. Given the fact that the vast majority of global futures and options markets do not permit fungibility and that existing OTC clearing facilities here and outside the U.S. also do not permit fungibility, how does your proposal ensure a level competitive playing field that allows U.S. clearing houses and exchanges the ability to compete?

Senator Pat Roberts
Senate Committee on Agriculture, Nutrition and Forestry
Questions for the Record
June 4, 2009

To Chairman Gensler:

1. What is your definition of "systemic risk?" How has this definition been applied to the financial bailouts? Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why propose treating all participants and products as if they do create a "systemic risk?"
2. The recent proposal by the Treasury Department for a systemic risk regulator calls for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?
3. How do you envision a systemic risk regulator will function in today's financial markets? What will be their primary role relative to the other regulatory agencies? Do you envision a regulator that would assume some of the duties of agencies such as OTS, SEC, and CFTC, and how do these authorities differ from the ones each currently possess independently?

To Mr. Dines:

1. How would the imposition of capital requirements for all dealers of OTC derivatives, as suggested by the Treasury Department's systemic risk regulator proposal, affect the OTC and derivatives markets and market participants? Would imposing such capital and licensing requirements drive non-financial intermediaries out of the derivatives market and if so what would be the economic effect of forcing manufacturers and other non-bank entities out of the commodities markets?

Senate Committee on Agriculture, Nutrition & Forestry
 Regulatory Reform and the Derivatives Markets
 Questions for the record
 Chairman Gary Gensler
 June 4, 2009

Senator Saxby Chambliss

- 1) You state in your testimony that swap dealers should be required to post capital and be subject to margin requirements. In his written testimony, Mr. Dines from Cargill states that “there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers.” He goes on to discuss the inappropriateness of eliminating non-financial institutions as competitors. Do you feel that the regulatory regime you have outlined today for the regulation of dealers would in fact result in only financial institutions remaining as sell-side swap participants?

Non-financial firms should be eligible to serve as swap dealers so long as they meet appropriate capital, margin, business conduct and reporting standards.

- 2) What information would CFTC find useful in a mandatory reporting regime? Would mandatory reporting for all transactions create more information than would be useful for regulatory analytical purposes? How would you structure mandatory reporting? Does the CFTC have the resources to analyze such a vast amount of data? Who do you feel should regulate the trade repositories you mention in your testimony, and do you envision one entity taking on this responsibility for all OTC transactions?

It is important that regulators be able to see both a particular trader's on- and off-exchange derivatives positions. Thus, derivatives dealers should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories would complement central clearing by providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the recorded information meets regulatory needs and that the repositories have strong business conduct practices. Trade repositories should collect and maintain the same data elements as the data collected for trades that are cleared. Based on the increased volume of information that would be received, the Commission would need to increase its resources devoted to the analysis and reporting of information.

- 3) I gather from your testimony that you and I agree that the need for customized transactions requires us to find a way to make sure businesses can still use these vital risk management tools under this new regulatory regime. In your testimony, as Secretary Geithner did in his letter to the Congress last month, you state that a transaction should be deemed standardized if a clearinghouse is willing to accept it for clearing. Do you feel that the clearinghouses are the most appropriate entity to determine if a contract is standardized?

The determination of what is standardized should be made by regulators pursuant to criteria established by Congress. Whether a clearinghouse will accept a product, however, is an appropriate factor that should be included among such criteria.

- 4) You have proposed product standardization so that "OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another." Are you proposing that the best capitalized clearing houses with the strongest creditworthiness be forced to accept the credit and risk of dealing with potentially weaker clearing houses?

Arrangements should be established that facilitate open access to clearinghouses and foster competition amongst exchanges and trading platforms. Such arrangements should mandate that clearinghouses have rigorous risk management standards.

- 5) Given the fact that the vast majority of global futures and options markets do not permit fungibility and that existing OTC clearing facilities here and outside the U.S. also do not permit fungibility, how does your proposal ensure a level competitive playing field that allows U.S. clearing houses and exchanges the ability to compete?

Any fungibility arrangements should be designed to promote competition amongst clearinghouses and exchanges.

Senator Pat Roberts

- 1) What is your definition of "systemic risk?" How has this definition been applied to the financial bailouts? Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why propose treating all participants and products as if they do create a "systemic risk?"

Systemic risk is the danger that financial problems or failure at a firm will have serious repercussions across financial markets and the economy. I believe that we must enact comprehensive regulation covering OTC derivatives dealers and markets to help lessen such risk and promote market transparency. Capital, margin and business conduct

standards as well as mandated central clearing will help lower risk to the economy and American public.

- 2) The recent proposal by the Treasury Department for a systemic risk regulator calls for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

Capital requirements for OTC dealers would lower risk to the financial system and economy. Dealers with less risk exposure would have lower capital requirements. Both financial and non-financial companies could register as OTC dealers. End users of OTC derivatives would not have capital requirements, but would be required to post some type of collateral.

- 3) How do you envision a systemic risk regulator will function in today's financial markets? What will be their primary role relative to the other regulatory agencies? Do you envision a regulator that would assume some of the duties of agencies such as OTS, SEC, and CFTC, and how do these authorities differ from the ones each currently possess independently?

Though Congress may designate a regulator to oversee large financial institutions posing risk to the broad economy, I believe that responsibility for conducting market oversight would remain with the market regulators such as the CFTC or SEC.

Senate Committee on Agriculture, Nutrition & Forestry
Regulatory Reform and the Derivatives Markets
Questions for the record
Mr. David Dines
June 4, 2009

Senator Pat Roberts

- 1) How would the imposition of capital requirements for all dealers of OTC derivatives, as suggested by the Treasury Department's systemic risk regulator proposal, affect the OTC and derivatives markets and market participants? Would imposing such capital and licensing requirements drive non-financial intermediaries out of the derivatives market and if so what would be the economic effect of forcing manufacturers and other non-bank entities out of the commodities markets?
 - This is a very important question. Certainly, some level of capitalization seems appropriate, but it should be activity and risk-based. Non-financial dealers have an important role in the markets, and have managed their businesses such as not to require any tax payer assistance. More importantly, the markets with non-financial dealers, primarily the agricultural and energy markets, did not create systemic risk during the recent financial crisis.
 - We need to strike the right balance between having the right levels of capital and licensing requirements, and allowing these non-financial dealers to be able to continue to operate.
 - Removing non-financial bank intermediaries offers no advancement in reducing system risk, lessens competition and will likely result in more expensive risk management opportunities.

○

**GLOBAL WARMING LEGISLATION:
CARBON MARKETS AND PRODUCER GROUPS**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————
SEPTEMBER 9, 2009
—————

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

—————
U.S. GOVERNMENT PRINTING OFFICE

62-716 PDF

WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

| | |
|------------------------------------|---------------------------|
| PATRICK J. LEAHY, Vermont | SAXBY CHAMBLISS, Georgia |
| KENT CONRAD, North Dakota | RICHARD G. LUGAR, Indiana |
| MAX BAUCUS, Montana | THAD COCHRAN, Mississippi |
| BLANCHE L. LINCOLN, Arkansas | MITCH McCONNELL, Kentucky |
| DEBBIE A. STABENOW, Michigan | PAT ROBERTS, Kansas |
| E. BENJAMIN NELSON, Nebraska | MIKE JOHANNIS, Nebraska |
| SHERROD BROWN, Ohio | CHARLES E. GRASSLEY, Iowa |
| ROBERT P. CASEY, Jr., Pennsylvania | JOHN THUNE, South Dakota |
| AMY KLOBUCHAR, Minnesota | |
| KIRSTEN GILLIBRAND, New York | |
| MICHAEL BENNET, Colorado | |

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| Global Warming Legislation: Carbon Markets and Producer Groups | 1 |

Wednesday, September 9, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|----|
| Harkin, Hon. Tom, U.S. Senator from the State of Iowa, Chairman, Committee on Agriculture, Nutrition, and Forestry | 1 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 3 |
| Thompson, Hon. Mike, U.S. Representative from the State of California | 41 |

Panel I

| | |
|---|----|
| Gensler, Hon. Gary, Chairman, U.S. Commodity Futures Trading Commission, Washington, DC | 5 |
| Glace, Joseph R., Vice President for Risk Management and Chief Risk Officer, Exelon Corporation, Chicago, Illinois | 23 |
| Miller, David, Chief Science Officer, AgraGate, and Research & Commodity Services Director, Iowa Farm Bureau Federation, West Des Moines, Iowa ... | 26 |
| Profeta, Timothy, Director, Nicholas Institute for Environmental Policy Solutions, Duke University, Durham, North Carolina | 21 |
| Winkler, Julie, Managing Director, Research and Product Development, CME Group, and Member, Board of Directors, Green Exchange Venture, Chicago, Illinois | 28 |

Panel II

| | |
|---|----|
| Beckstoffer, W. Andy, Chairman and Chief Executive Officer, Beckstoffer Vineyards, Rutherford, California | 13 |
| Brubaker, Luke, Brubaker Farms, Mount Joy, Pennsylvania | 47 |
| Rehermann, Frank, Chairman, USA Rice Producers' Group, Live Oak, California | 15 |
| Yoder, Fred, Past President, National Corn Growers Association, Plain City, Ohio | 49 |

APPENDIX

| | |
|--------------------------------|-----|
| PREPARED STATEMENTS: | |
| Gillibrand, Hon. Kirsten | 58 |
| Grassley, Hon. Chuck | 68 |
| Thune, Hon. John | 62 |
| Beckstoffer, W. Andy | 65 |
| Brubaker, Luke | 71 |
| Gensler, Hon. Gary | 74 |
| Glace, Joseph R. | 81 |
| Miller, David | 90 |
| Profeta, Timothy | 106 |
| Rehermann, Frank | 116 |
| Winkler, Julie | 121 |
| Yoder, Fred | 132 |

IV

| | Page |
|--|------|
| DOCUMENTS SUBMITTED FOR THE RECORD: | |
| Brubaker, Luke : | |
| Darling International Inc., prepared statement | 140 |
| National Milk Producers Federation, prepared statement | 150 |
| QUESTION AND ANSWER: | |
| Harkin, Hon. Tom: | |
| Written questions for Andy W. Beckstoffer | 162 |
| Written questions for Luke Brubaker | 165 |
| Written questions for Gary Gensler | 171 |
| Written questions for Joseph Glace | 173 |
| Written questions for Dave Miller | 174 |
| Written questions for Timothy Profeta | 176 |
| Written questions for Frank Rehermann | 180 |
| Written questions for Julie Winkler | 184 |
| Written questions for Fred Yoder | 188 |
| Grassley, Hon. Charles E.: | |
| Written questions for Andy W. Beckstoffer | 163 |
| Written questions for Luke Brubaker | 168 |
| Written questions for Joseph Glace | 173 |
| Written questions for Dave Miller | 174 |
| Written questions for Timothy Profeta | 177 |
| Written questions for Frank Rehermann | 181 |
| Written questions for Julie Winkler | 186 |
| Written questions for Fred Yoder | 188 |
| Thune, Hon. John: | |
| Written questions for Andy W. Beckstoffer | 164 |
| Written questions for Luke Brubaker | 169 |
| Written questions for Gary Gensler | 171 |
| Written questions for Joseph Glace | 173 |
| Written questions for Timothy Profeta | 178 |
| Written questions for Frank Rehermann | 182 |
| Written questions for Fred Yoder | 189 |
| Roberts, Hon. Pat: | |
| Written questions for Luke Brubaker | 167 |
| Written questions for Frank Rehermann | 180 |
| Written questions for Fred Yoder | 188 |
| Beckstoffer, W. Andy: | |
| Written responses to questions from Hon. Tom Harkin | 190 |
| Written responses to questions from Hon. Charles E. Grassley | 191 |
| Written responses to questions from Hon. John Thune | 192 |
| Brubaker, Luke: | |
| Written responses to questions from Hon. Tom Harkin | 193 |
| Written responses to questions from Hon. Charles E. Grassley | 196 |
| Written responses to questions from Hon. John Thune | 197 |
| Written responses to questions from Hon. Pat Roberts | 195 |
| Gensler, Hon. Gary: | |
| Written responses to questions from Hon. Tom Harkin | 199 |
| Written responses to questions from Hon. John Thune | 199 |
| Glace, Joseph R.: | |
| Written responses to questions from Hon. Tom Harkin | 202 |
| Written responses to questions from Hon. Charles E. Grassley | 204 |
| Written responses to questions from Hon. John Thune | 205 |
| Miller, David: | |
| Written responses to questions from Hon. Tom Harkin | 207 |
| Written responses to questions from Hon. Charles E. Grassley | 207 |
| Profeta, Timothy: | |
| Written responses to questions from Hon. Tom Harkin | 213 |
| Written responses to questions from Hon. Charles E. Grassley | 214 |
| Written responses to questions from Hon. John Thune | 215 |
| Rehermann, Frank: | |
| Written responses to questions from Hon. Tom Harkin | 217 |
| Written responses to questions from Hon. Charles E. Grassley | 218 |
| Written responses to questions from Hon. John Thune | 219 |
| Written responses to questions from Hon. Pat Roberts | 217 |
| Winkler, Julie: | |
| Written responses to questions from Hon. Tom Harkin | 221 |
| Written responses to questions from Hon. Charles E. Grassley | 223 |

| | Page |
|--|------|
| Yoder, Fred: | |
| Written responses to questions from Hon. Tom Harkin | 225 |
| Written responses to questions from Hon. Charles E. Grassley | 226 |
| Written responses to questions from Hon. John Thune | 228 |
| Written responses to questions from Hon. Pat Roberts | 225 |

**GLOBAL WARMING LEGISLATION:
CARBON MARKETS AND PRODUCER GROUPS**

Wednesday, September 9, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 10 a.m., in room SH-216, Hart Senate Office Building, Hon. Tom Harkin, Chairman of the Committee, presiding.

Present: Senators Harkin, Conrad, Lincoln, Stabenow, Casey, Klobuchar, Gillibrand, Chambliss, Lugar, Johanns, Grassley, and Thune.

**STATEMENT OF HON. TOM HARKIN, U.S. SENATOR FROM THE
STATE OF IOWA, CHAIRMAN, COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY**

Chairman HARKIN. Good morning, and welcome to this hearing of the Committee on Agriculture, Nutrition, and Forestry on proposals for global warming legislation.

Senator Chambliss is on his way. We have to get started because we are up against kind of a time crunch here. This hearing will adjourn promptly at—no later than 12:30.

Our witnesses today will help us examine issues in structuring and regulating markets for greenhouse gas emission allowances. They will share the views of a cross-section of agricultural producers regarding the pending legislation.

Let me start by reiterating the urgency and importance of addressing global warming. I had a chart here that I keep using, if I can have it here again. I do not know if you can see it from the back. But as this chart shows, the concentration of carbon dioxide in the atmosphere has increased by about 50 percent over the last 150 years. We are now seeing the effects of that in rising global average temperatures. You can just see how rapidly it is going up increasingly from about 1980 on up at an ever increasing rate. And the ten warmest years on record, all occurred in the past 12 years. And just last week, Science magazine reported that temperatures in the Arctic are at the highest levels in the past 2,000 years.

In plain words, we humans are changing the Earth's climate. And while we do not know precisely all the consequences of our current climate trends, we do know they are likely to include more severe storms, more frequent and severe heat waves, in addition to rising seas and higher temperatures.

(1)

I agree with the majority of Americans who say that we must act to mitigate these effects. We must not simply leave future generations to cope with a hotter and more dangerous climate.

Our Committee began to consider the role of agriculture and forestry in reducing greenhouse gas emissions and the consequences of cap-and-trade at our first hearing in July. Today we will examine these issues at the farm level. We will hear from a corn and soybean farmer, a rice farmer, a grape grower and vintner, and a dairyman. In addition, we are obviously going to hear from the Chairman of the Commodity Futures Trading Commission at the outset to talk about the aspect of how these markets might be regulated by the CFTC.

Now, while we could not include representatives of every type of agriculture, I trust the testimony and discussions of these witnesses will begin to provide us with a better sense of on-the-ground effects that our agriculture sector is likely to see under global warming and under mitigation strategies.

We will hear from farmers and ranchers how they might benefit through actions such as the installation of digesters to reduce methane emissions from livestock production and other forms of methane emissions; cropping practices such as no-till farming or applications of biochar that increase carbon contents of soils; increased demand for renewable energy resources such as biofuels and wind power.

As the Committee with the responsibility for legislation governing commodity futures markets, the Senate is looking for our guidance on how to structure and regulate markets, and our first two panels will provide testimony on that issue.

If we are serious about a cap-and-trade system, we must get the trading part right, and that means effective, practical regulation and oversight so the markets work. The benefits of a cap-and-trade approach have been clearly stated: use the market system to reach the least expensive path to reducing greenhouse gas emissions. But the potential costs if these carbon markets blow up cannot be overstated. Markets that are not properly and carefully regulated will blow up, and the economy and environmental goals of the program will blow up with it. This market has the potential to be a very big and very complicated part with a lot of money at stake, and we have seen what can happen when there is not sufficient transparency, accountability, or limits on risky behavior in markets.

We should not put too much faith in the markets alone to deliver results. Do we want to repeat the adverse impacts of excessive speculation in the crude oil market last year for carbon? Do we want to replicate for allowances and offsets the free-wheeling derivatives market that helped bring down our economy?

We must avoid the dangers of excessive speculation or price volatility or so-called innovation that turns out to be all about short-term profit and simply creates greater risk instead of just managing the risk.

Some of the ideology and recklessness that helped drive our economy and our markets over the cliff are now surfacing in discussion of a cap-and-trade system. I find this troubling. We have learned a lot from years of both regulating commodities and previous cap-and-trade efforts from both regional and international carbon mar-

kets, and it is imperative that we incorporate those lessons into a properly regulated new carbon-trading regime.

In closing, I want to thank Senator Chambliss, thank you and all of your staff for the support in planning this hearing. I look forward to working with you as we outline the appropriate representation of agriculture and forestry as we provide guidance for the structure and regulation of greenhouse gas emissions allowances markets.

I would now turn to Senator Chambliss for opening comments.

**STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM
THE STATE OF GEORGIA**

Senator CHAMBLISS. Well, thank you, Mr. Chairman, and thanks for holding this second hearing on cap-and-trade and its effects on agriculture. In spite of the news I saw on TV this morning, I hope you are going to be holding many, many more agriculture hearings. Things do happen in politics, but you have been a great friend on this as well as every other issue involving agriculture.

I suspect that you and our colleagues on this Committee heard from many constituents, not just those involved in agriculture, over the August recess on cap-and-trade and climate legislation. I certainly did. It was clear to me that they want the Senate to very carefully consider all aspects of this issue and not rush to pass legislation.

I look forward to hearing from CFTC Chairman Gensler who has certainly jumped into the fray on a number of issues, and, Mr. Chairman, we appreciate your great leadership, your involvement, plus your continued dialog with the Hill. You committed to do that during your confirmation process, and I thank you for doing exactly what you said you were going to do.

Additionally, we will hear directly from those that will be regulated under a cap-and-trade system. Exelon, as an energy generator, will be required to purchase allowances and, therefore, deserves a workable risk management system within any newly created market. And CME Group, with its pending Green Exchange venture, will be subject to CFTC regulation as a designated contract market.

I expect any domestic carbon market would work much like existing commodity markets, though with a few notable differences. As the Committee with jurisdiction over commodity pricing and trading, we need to ensure we are fulfilling our responsibilities and weighing in with our colleagues on the issue of regulating any such carbon commodity market.

The issue of market regulation has not received the careful consideration that it justly deserves. To date, this Committee has focused its discussions on the impact on farmers and ranchers, and I am pleased that we will continue to hear about that important topic today.

As many of you know, the Texas A&M University's Agriculture and Food Policy Center recently released a report using its Representative Farms Data base to model the effects of the House climate bill on the farm level. For those of you here today who are not familiar with representative farm studies, they are commonly used in agriculture to model the effects of proposed legislation on

the micro level or at the individual farm level. The AFPC has been doing this type of work for Congress for more than 25 years. While the macroeconomic studies help Congress understand the effects of proposed legislation on agriculture as an industry, it is the representative farms that provide the ground truth of these proposals.

The ground truth that this study shows is very serious. The study says that 71 out of 98 farms will be worse off under the House cap-and-trade plan, even in the early years of the program. Most concerning, the 27 farms that benefit do so only because other producers go out of business. Not one rice farm or cattle ranch benefits, while only one cotton operation and one dairy benefit, mainly due to the fact that they both grow a significant amount of feed grains.

While intuitively we knew that there would be winners and losers in cap-and-trade, we did not know that the benefits and costs would be so disproportionate and regionally perverse. How can we as members of the Agriculture Committee endorse a policy that disproportionately favors certain commodities and, thus, only one part of the country at the expense of all others?

Mr. Chairman, I know you are very proud of your corn and soybean farmers in Iowa. You should be. But how can I reasonably support a bill that will put farmers in Georgia in a worse position or farms in California or farms in the Southwest, while transferring the benefits to the Corn Belt through attrition?

I look forward to hearing from the producer panel today with their thoughts on the House bill and the likely effects it will have on producers as reflected in this study. Given the complexities of the market issues and the negative effects likely to be felt by producers, Mr. Chairman, I think you were wise to plan for additional hearings. I hope our staffs can get together during this week and plan for the next hearing, and I thank you again and appreciate your leadership and your work on this issue.

Chairman HARKIN. Well, thank you very much, Senator Chambliss. Again, you are correct, we have to make sure that agriculture is treated fairly and equitably in this cap-and-trade legislation. I am committed to that. And we have to be cognizant of its varied impacts, depending upon what type of agriculture you are in and what part of the country you live in. And, hopefully, we will be able to address those and work those out as we move ahead on that. Obviously, we do not have jurisdiction over all that, but we will have jurisdiction over at least making our intents known to the Environment and Public Works Committee, I guess it is, before they start marking up.

We have a full panel today. As I announced earlier, we have to adjourn here by no later than 12:30. I am going to ask that each witness take 6 minutes. I am going to be—I have never been very strict on the gavel before, allowing people to go over, but I think we are going to have a lot of people who want to ask questions here today. So I am going to ask each of our panelists no more than 6 minutes at the maximum to discuss your papers. That will give us 54 minutes, and that will leave us about an hour and a half for questions. And I am going to ask for 5-minute rounds on questions also.

So we will start off with the Honorable Gary Gensler, Chairman of the U.S. Commodity Futures Trading Commission. Your statement will be made a part of the record in its entirety, as will all statements—and I read most of them last night—be made part of the record in their entirety. I would ask you just to sum up, as I said, in no more than 6 minutes.

Mr. Gensler, welcome again to the Committee, and please proceed.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. GENSLER. Thank you, Mr. Chairman and Ranking Member Chambliss. It is good to be back together with you and members of the Committee. My testimony will focus on the Commodity Futures Trading Commission's experience regulating emissions trading markets and how we can apply those experiences to trading in government-issued greenhouse gas allowances and offset credits. I am testifying on behalf of the full Commission, our four Commissioners, as I was glad to do the last time I was with you as well.

We believe that effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are five components that I believe should be considered: first, the standard setting and allocation, and, of course, the environmental compliance that goes along with that; second is recordkeeping, maintaining a registry for the allowances and offsets; third, overseeing trade execution systems; fourth, overseeing clearing of trades; and, fifth, protecting against fraud, manipulation, and other abuses.

Now, in terms of these first two components, those fall within the expertise of other agencies other than the Commodity Futures Trading Commission. In other words, there are others better equipped to regulate the "cap" part of cap-and-trade.

EPA, for example, currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain and Clean Air Market Acts. On a smaller scale, a group of ten States from Maryland up to Maine has the Regional Greenhouse Gas Initiative and issues allowances on greenhouse gas emissions. And in each of those cases, other entities issue the allowances, do the environmental compliance, and maintain the registry. The constant, however, in all of these markets is the CFTC currently regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the "trade" part of cap-and-trade.

We have broad experience in the latter three components of carbon trading: regulating the trade execution systems and clearing of trades and protecting against fraud, manipulation, and other abuses. The Commission already oversees this trading and clearing of emissions futures and options contracts of the New York Mercantile Exchange and the Chicago Climate Futures Exchange. Additionally, just last month, under direction from Congress in last year's farm bill, the Commission began looking into if the Carbon Financial Instrument spot contract traded on what is called the Chicago Climate Exchange, a sister exchange to the futures exchange, is actually a significant price discovery contract. So the

Commission has abundant experience in the regulation of centralized marketplaces, and should Congress seek to regulate cash markets for emission instruments, the Commission is well suited to carry out that function as well.

The Commission has thorough processes to ensure that exchanges and clearinghouses are in place to protect market participants and ensure fair and orderly markets, and that trading in these exchanges comply with the law and regulations. Our surveillance staff keeps a close eye on the signs of manipulation and congestion and determines how to best address, and we have the authority to set position limits as well within these markets.

The CFTC also has wide-ranging transparency initiatives, and it is designed to provide as much information to the American public as possible. So should you go forward with the cap-and-trade legislation, the CFTC would work with other regulators and market users to make sure that the transactions that occur—transactions that would have to be recorded on a registry kept by the EPA or USDA or others—that that registry be updated on a very real-time basis so that there would be market transparency.

The CFTC, however, if you were to move forward, would need additional resources. I fear that I keep saying this, but the staff and technology to effectively regulate the expanded carbon markets. We have the expertise. We would probably need some additional resources.

We also would want to work with Congress and look forward to working with Congress to enact broad, comprehensive reform of the over-the-counter derivatives marketplace. This reform must also include an oversight of the emissions and allowance markets if they were to develop in the over-the-counter space as well.

As Congress moves forward and possibly regulated cap-and-trade legislation, I look forward to working with this Committee to ensure that the new markets are comprehensively and effectively regulated. I believe the CFTC does have the expertise and experience necessary to help regulate the growth in carbon markets, and we must protect against the same hazards in the carbon markets that we currently guard against in other commodity futures markets, particularly fraud, manipulation, and other abuses.

I thank you for inviting me here today. I look forward to your questions. I did it in 4 minutes.

[The prepared statement of Mr. Gensler can be found on page 74 in the appendix.]

Chairman HARKIN. That is perfect. Thank you very much, Chairman Gensler, and I will say that we will have just 5-minute rounds. Again, I hope that we will respect each other's time on that and try to limit it to 5 minutes, and I will start off and start my clock at 5 minutes.

Chairman Gensler, two things I want to ask. If we have a cap-and-trade system for greenhouse gas emissions, is there really a need for an over-the-counter market? And, second, I am concerned about derivatives. If we allow trading of derivatives on greenhouse gas offsets and allowances, would it make sense to require at the end date of a future or other derivative contract that there be a transfer of the actual offset or allowance, not simply a cash settlement?

I ask both those questions because of my concern about derivatives on offsets or allowances and then derivatives on those derivatives and derivatives on those derivatives, and we are right back where we started before. And so I repeat: Is there a need for an over-the-counter market? And, second, should there at some point near the settlement date be some delivery of the actual offset or allowance and not simply a cash settlement?

Mr. GENSLER. Mr. Chairman, I appreciate your question. It continues a dialog we have had before in these hearing rooms. I believe that all futures on these carbon markets should be on exchanges, just as we have all futures for corn and wheat and oil and natural gas on regulated exchanges, and we are equipped to do that. I believe working with Congress, we need to make sure that any—what is currently called over-the-counter derivatives or swaps on these are brought under regulation, that the dealers in carbon markets, just like the dealers in oil or in wheat markets, should be fully regulated for capital and so forth; and that the standard contract should also be brought on exchange rates, standard swap contracts for these carbon allowances.

But I do believe that there are going to be times where there is going to be tailored product that cannot readily be brought onto a centralized clearing. An example might be that if you wanted to build a utility in Iowa or in Georgia or in any one of your States, and that utility wants to bring on a financing for 10 years or even 20 years, you might want to lock in—that utility might want to lock in the price of the carbon emissions out 10 and 20 years, and that might not be readily available on a market.

I do believe, though, working with Congress, that contract too should be under regulation by making sure that the dealer who is transacting that has to have the capital, has to report it to the regulators, the EPA and possibly other regulators regulating the cap side, and also to the regulators regulating the trading side as well.

Chairman HARKIN. How do we control the possible proliferation of derivatives on greenhouse gas emissions and the speculation thereon?

Mr. GENSLER. Well, I think as we are working with Congress to bring the whole over-the-counter derivatives marketplace under regulation, we must do that here as well; that the dealers in these contracts must be regulated for transparency, 100 percent of their transactions, whether they be tailored or standardized; but also if you were to move forward and ask the CFTC to regulate that, that we be able to set aggregate position limits across those traded in the futures market as well as those in what might be in this tailored or still bilateral market.

Chairman HARKIN. One last thing. I hope that you and the other Commissioners and your staffs will continue to monitor what is being done here—not here, but in the Congress—so that at the appropriate time, when this legislation looks like it is mature and is ready to go to the floor, that we could get from you what resources you would need to carry out the provisions of the bill in order to provide adequate oversight and regulation.

Mr. GENSLER. We will do that, Mr. Chairman, and I commit to work with you and the appropriators to share that with you.

Chairman HARKIN. I just want to make sure they just do not dump on your lap all this stuff without the resources that you would need to regulate and have this oversight.

Mr. GENSLER. Thank you.

Chairman HARKIN. Thank you, Mr. Chairman. Thank you, Chairman Gensler.

Senator Chambliss?

Senator CHAMBLISS. Thank you, Mr. Chairman. And let me just echo that, Mr. Chairman, because you and I have talked before about the fact that I think you are underresourced right now for what you have been charged to do; and I think you are finding that out every day you go to the office. So we need to make sure as we go through the whole financial overhaul, restructuring that we do not load you up with something else that would prevent you from being able to do your current job.

I want to continue along that same line. I understand what you are saying about seeking to regulate all of these contracts and put them all on exchanges, but we know that today where the only cap-and-trade market that is functioning is in Europe, about 75 percent of contracts are traded over the counter. If they have been at this for a while and they are trading that high a percentage over the counter, what are we going to do different to try to bring those contracts onto the exchange?

Mr. GENSLER. Senator, I believe that you are right to look—Europe does give us some guidelines as to what might happen here. There are actually three marketplaces. There is the futures marketplace, where actually in Europe that market is all on exchange, the futures. There is a cash marketplace, and I think that is what you refer to. Some of that is off-exchange, of course.

If I could say it here, if a farmer in Iowa wanted to transact and sell an offset to another farmer in Iowa or maybe in Georgia, they might do that over the counter.

Third, there is the swaps or derivatives marketplace. I believe that we have to have 100 percent of the futures marketplace regulated, just as we do in corn and wheat and oil. I believe that we have to have the standard derivatives contracts onto exchanges, as we are trying to do with Congress in other contracts as well, and that leaves the question on the cash markets. Can one farmer transact with another farmer? And I think that is probably appropriate. But if a centralized market comes together, I think we have to regulate that centralized market to protect against fraud and manipulation. These election trading platforms should have oversight and regulation, I believe.

Senator CHAMBLISS. Does the proposal by the administration that has come forward from Treasury, and while it is not firm yet by any means—and I know you have some issues with it. We have some issues with it. But the proposal that is out there, does that, do you think, give you the appropriate power to regulate the carbon contracts also? Or are we going to have to make some changes in that?

Mr. GENSLER. I believe that the administration sent up to Congress a very strong package and that that package actually, to your question, does cover in the definitions of swaps contracts on emissions, allowances, and offsets. If it does not, we will have to tweak

it, along with Congress, but the intent was, working with Treasury, that it did cover that.

Senator CHAMBLISS. Let us talk for a minute about this issue of standardized versus specialized contract, and we have got the same issue, obviously, out there today with a number of other commodities. But is there going to be any difference in trying to say that a contract on a carbon emission is a standardized contract if it does so-and-so versus an interest rate contract that is standardized if it does so-and-so? Where are we going to come down on this? And how are we going to define "standardized"?

Mr. GENSLER. I think it is very similar. What the administration put forward, and I support, is that the biases toward bringing more transparency and lowering risk that standardized products are on exchanges or trading platforms and centralized clearing, if a clearinghouse accepted a carbon allowance swap to be cleared, then the presumption would be that it would be standardized.

That still might be the case that if somebody has to finance a 10- or 20-year utility plant, they could do that. But most likely the 1-year, the 2-year, or the 3-year carbon allowance trading would be largely standardized—maybe not entirely, but largely standardized.

Senator CHAMBLISS. OK. Just in addition to staying in touch with us relative to the resources, I think this issue is going to be critical with respect to the markets you have jurisdiction over now as well as any carbon contracts. And it is another reason I think we better be careful as we move ahead with cap-and-trade to make sure we get it right, and that if we are going to clear all of these contracts, with few exceptions—and I agree with you, I hope we can do that—we need to make sure that the traders out there on both sides of these contracts really have some direction. And I think we have got to be very careful that we give them the right kind of language to know what it is they are going to be dealing with.

Mr. GENSLER. Senator, I agree, and I also think you have highlighted the intersection of Congress' work between cap-and-trade and over-the-counter derivatives reform. These two legislative initiatives might be timed a little differently and through different committees at times, but they very much relate in the regards you just said.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Chambliss. Senator Klobuchar was next, she is not here. Then we turn to Senator Grassley, Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman. Thank you, Mr. Gensler.

In your testimony, you state that emissions contract markets operate no differently than other commodity markets that CFTC regulates. However, there are members of the following panel that say these markets are quite different because the market is mandated by a Government-imposed cap and the market is ever reducing supply. So would you please reconcile these two points of view that the market really is different, but should be regulated in a uniform way as other commodities?

Mr. GENSLER. There are many similarities, like in the agricultural products this Committee oversees and their futures in corn

and wheat. There is an annual crop in a sense. There is an annual crop of allowances that are issued. It may be reducing instead of growing. Hopefully we think of corn and wheat growing, and this might be reducing.

It has some similarities to even Treasury bonds. Treasuries are issued by the Government. These are issued. Again, we would like to think that there would be fewer treasuries, but, unfortunately, there seems to be more every year. So there are many similarities.

Where the similarities depart—I would certainly look forward to working with this Committee and Congress to see if there is additional oversight we would need. But I think in terms of overseeing a trading market, there are far more similarities than there are differences to all the other products that are overseen, whether it be the agricultural, the energy, or the financial products that are currently overseen in the futures markets.

Senator GRASSLEY. Next, you mention briefly in your testimony about the recent public hearings that CFTC held on whether to set position limits on energy markets like we do in agriculture markets. Expand for me and the Committee on your findings at the hearings.

Mr. GENSLER. We had three hearings where we had 23 witnesses, and we had over 400 comment letters that came in. What we are looking at is Congress really directed in our statute that the CFTC set position limits—this was back in the 1930's—and we did so in agricultural products and still do so. We did in energy products with the help of the exchanges through June of 2001. And, in fact, it was just 8 years ago that we sort of backed away from that, and the exchanges now have what is called accountability levels rather than hard limits.

So we are taking a very close look as a Commission at this, all the comments, the thought really being that markets—how do we best promote a market, the fair and orderly market that no one party is so highly concentrated in that market that actually by being so large in the market, it sort of distorts a market and limits liquidity and limits the market function rather than adds to the market?

It is a lot to move forward, but if we were to move forward—and I say “if” because we have a Commission process—we are looking to do that in the fall with proposed rules. We would take more public comment through the usual means that we do that.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman HARKIN. OK. Thank you.

Senator KLOBUCHAR?

Senator KLOBUCHAR. Thank you very much. Thank you, Chairman.

Over 25 years ago, Minnesota was the first State in the Nation to adopt legislation to address acid rain, and since then, as you know, President George H.W. Bush in 1990 created the Acid Rain Emissions Trading Program. And so our country has had some experience with this, and I know this is an emissions program that is regulated by the EPA. However, the CFTC has oversight of emissions trading. Could you comment about how that is working and any analogies you can draw with the proposals before us?

Mr. GENSLER. Senator, I thank you. I did not know it was your home State that started that.

I think it has worked well. It is a small market, and much smaller than these anticipated markets. But under the Acid Rain and Clean Air Act, two products—sulfur dioxide and nitrogen oxide—are limited, and that is all done by the EPA. There is no offset program. It is more an allowance program. But then there are futures trading on these various contracts, and they are traded on something called the Chicago Climate Futures Exchange, and then also there is, I will call it NYMEX, or New York Mercantile Exchange, has—and I think you have a witness later today about that.

Those futures trade. They are under our current regulatory regime. So far there has not been any issues that are not similar to the other things that we oversee to protect against fraud manipulation. We oversee the clearing and the exchanges on these.

Senator KLOBUCHAR. And do you think it has been a success, the trading on that?

Mr. GENSLER. I think that the trading—I am not going to speak to the environmental side, which I have read a lot about, but it is other expertise. I think the trading has brought greater price discovery, that those participants in the market who want to transact, have a broad national market; that natural hedgers, just like in corn and wheat and oil, have somebody on the other side who might take the other side, who is a speculator but is setting a price with them to ensure that outcome.

So I think in that regard, yes, it has been a success. It is still a very small market, of course.

Senator KLOBUCHAR. OK. So you think you could draw some knowledge and wisdom from that, but that this would be a much bigger project to tackle?

Mr. GENSLER. I think that is right.

Senator KLOBUCHAR. OK. And how does it compare with what is happening with the EU and how the EU has handled it?

Mr. GENSLER. Well, in Europe, you are right to mention that they, too, have gone forward, but they have a greenhouse gas initiative. They have two contracts, two trading—one is on the allowances, the EU allowances, and one is on emissions reductions or what we here call “offsets.” And those two contracts trade very actively on the European Climate Exchange and on something called Bluenext, two different exchanges. One is regulated by a French financial regulator, the other by the U.K. regulator.

The open interest there, interestingly, is about the size—I just looked at it last night—about half a million contracts on the European Climate Exchange, which is about the size in open interest in corn or wheat, which are about 300,000 or 400,000 contracts. It is about a third of the size of WTI oil, which is about a million and a half open interest, just to give you a sense of the size of that market.

Senator KLOBUCHAR. OK. Since you have mentioned wheat a few times—and this is a little different topic—in January, the GAO issued a report in response to House Ag Committee Chairman Collin Peterson, who is a Minnesota Congressman, and he asked the GAO to examine issues surrounding the regulation of futures trading, as you know. And once noteworthy aspect of the report

was the conclusion that eight empirical studies generally found limited statistical evidence of a causal relationship between speculation in the futures market and changes in commodity prices. A recent report by Homeland Security revealed that speculation was, in fact, one of the major causes behind the recent fluctuations in wheat.

So could you comment on these reports and the connection between speculation and volatility of commodity prices?

Mr. GENSLER. We have recently—I think it was just last week—promoted greater transparency in these markets by disaggregating our weekly reports. We now also break out the index investors in the market. I think that the best role for the CFTC is to help promote transparency so market analysts can best answer the Senator's question.

I do think as it relates to wheat specifically, if I can narrow that, I do think that index investing in the wheat contract in Chicago—and it is a very narrow topic—probably did contribute to what is called a lack of convergence in the wheat market. That is, the price of futures and cash in the wheat market has not come together. And so I think a little bit over half of that marketplace in the Chicago wheat market is index investors, and I think that is one of the contributing—not the only factors, but contributing factors to the lack of wheat convergence.

Senator KLOBUCHAR. Thank you very much.

Chairman HARKIN. Thank you.

Now Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman, and welcome, Chairman Gensler.

Mr. GENSLER. Good to be back in front of you.

Senator STABENOW. It is good to see you. Just as one member, I would indicate, and speaking to our appropriations leaders, that if we move forward on cap-and-trade, we certainly need to address resources to make sure the CFTC is able to fully address all of the issues involved in this, which are incredibly important.

I wanted to follow up more on the over-the-counter issue, which I think is a very important piece of all of this, and not only as we look at reforms that we are addressing here in this country, but in the House bill they would allow U.S.-covered entities to use international carbon instruments by the EU, the emissions trading system, or the UN's Clean Development mechanism to meet our domestic compliance purposes.

So given that approximately 75 percent of all the emission trading in Europe takes place over the counter, how do you see commonizing international carbon instrument compliance if the U.S. legislation were to restrict such instruments for compliance purposes to those traded on regulatory markets?

A second question would be, as a follow-up: Has the CFTC conducted an analysis of what impacts, if any, the administration's Over-the-Counter Derivatives Markets Act of 2009 would have on the domestic and international carbon markets?

Mr. GENSLER. Well, in the first question, I think that international cooperation is critical. I do not know where Congress will come out in terms of whether those allowances or offset allowances

over in Europe will be allowed here. But even if they are not, there is going to be some relationship of these two marketplaces.

I believe that we have to have full transparency even into the over-the-counter market. The over-the-counter swap market may still be allowed, but it should be fully regulated. We should have the transparency. Any dealer in those markets should be registered, and we should have 100 percent transparency into that, and we should report the aggregate positions.

In terms of the second question about the over-the-counter reform that has been proposed by the administration, it does include oversight of the carbon allowance markets. We have not had a separate study of that because it is such a small part, it is a small market in nitrogen oxide and in sulfur dioxide. There is a small market also between ten States, in New England down to my home State, Maryland, called the Regional Greenhouse Gas Initiative. But, again, it is small. We have not had an independent study yet.

But I do think that if we move forward, we must cover carbon allowances in what is being considered in the over-the-counter derivatives legislation that the administration sent up.

Senator KLOBUCHAR. So, just to recap, you are not seeing a problem in between what is happening internationally and at least at this point what the House bill has said in terms of using—allowing the international emissions standards versus what we are doing here? I mean, harmonizing that, would you have any recommendations as it relates to that?

Mr. GENSLER. My recommendation would be if an allowance or an offset there is fungible into a U.S. system, if the Congress decides that it is fungible, then we want to make sure, just as oil is fungible worldwide, that we are looking at the aggregate markets, that we would have to be working even more closely with the FSA currently overseas and then there is a French financial regulator that oversees those trading markets over there. So fungibility puts a greater burden—this fungibility is a global fungibility of offsets. It puts a greater burden on the regulators to have a coordinated approach.

Senator KLOBUCHAR. And do you feel confident that you can achieve that?

Mr. GENSLER. I think we can, but it is a greater challenge because sometimes they have a different point of view than we do on how to regulate these markets.

Senator KLOBUCHAR. All right. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Stabenow.

Now Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and, Chairman Gensler, thank you for your appearance again. You have appeared in front of many Senate committees, and we are grateful you are here again.

I am going to give you a little commercial in a moment, but I wanted to, first of all—that is because of your Pennsylvania connections, by the way, but I also want to commend your work. But we are here today to talk about a challenge that faces not just our country but the world, and the basic challenge is how to slow, stop, and reverse global warming. Obviously, there is legislation that is in the House, and the Senate is working on this as well. As we do

that, we have to be able to balance and take into serious consideration and implement strategies within the legislation to make sure that our farm families are not adversely impacted. I believe, though, by as much as it is a challenge, it is an opportunity. It is an opportunity not just to stop global warming and keep our environment clean, but it is also a jobs opportunity, to create jobs and also to enhance our national security.

We know that rural America, the families in rural America have been hammered by this recession. In fact, some of them were adversely impacted long before the recession with the high energy costs. Senator Gillibrand and I were just talking about our dairy farmers, all across States like Pennsylvania and New York and so many others, that have been adversely impacted.

We are grateful today that you are here. We are grateful for your work in restoring confidence and giving a sense of strategy and a sense of purpose to the work that you do as a regulatory body that needs, as I realize, more resources.

I know that later today we will hear from, among others, Luke Brubaker from Pennsylvania, and he was kind enough to provide some Pennsylvania crop insurance advertising. We are grateful for that, and we are grateful it was on the top of the pile of our papers. I want to thank him on behalf of the people of Pennsylvania.

Senator KLOBUCHAR. Would you like one?

Senator CASEY. Senator Klobuchar is passing out extra copies.

But that all leads back to you because I know you are a Wharton graduate. We are pretty proud of you, and we hope you come back to Pennsylvania and live and pay taxes and do all that.

[Laughter.]

Senator CASEY. But in the meantime, you have got a lot of work to do here in Washington.

I was especially impressed by and happy about the fact that in your testimony you said—I am looking at page 2. You said, and I quote, “As Congress moves forward with... cap-and-trade legislation, I believe it should ensure that there is a comprehensive regulatory framework over the expanded carbon markets...” I think those are very important words, “comprehensive regulatory framework.” And then later, on page 6, you emphasized ensuring that “all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis.” And all of the concerns that you have raised about how we do this to get it right and to be able to regulate it.

I will ask in the very limited time that I have left, because I know I have talked for a couple of minutes here as a preface, but in terms of your resources, both human, staff resources as well as technology, tell us about what you need to do your job generally, but also in particular, if legislation is passed to give you this additional assignment, so to speak. What would you need specifically or as best you can guess in terms of people and resources? And on the technology part of it, is it both hardware, software, and other aspects of technologies?

I know it is a broad question, but you have all of a minute to answer.

Mr. GENSLER. Well, I thank you, and I appreciate the advertisement. If there is anything you like in what I do, you can credit it

to my University of Pennsylvania education. Anything that you do not like, you could credit to my wayward days elsewhere.

[Laughter.]

Mr. GENSLER. But in terms of needed resources, with Congress' help we have just gotten back to the size we were in 1999, about 570 people. We are going to submit, the Office of Management and Budget, to Congress in, I think, a week's time a much larger number, but it is going to be what we really believe we need to do our current duties. In technology, it is mostly software upgrades. We need to take our position and trading surveillance systems, probably spend on the order of \$11 or \$12 million, but we do not know—it is probably a multi-year project—to upgrade that to 21st century surveillance rather than right now it is too much after-the-fact surveillance.

Senator CASEY. Well, thank you very much, and, Mr. Chairman, both Chairman Gensler and I have been very careful on our time, so I will stop right here. Thank you.

Chairman HARKIN. Thank you very much, Senator Casey.

Senator JOHANNIS?

Senator JOHANNIS. Thank you, Mr. Chairman. Let me, if I might, start my questions with maybe a little bit of context. In our last hearing with the Agriculture Committee, I asked a question of one of the panelists, Lisa Jackson. If we do what the House bill wants us to do, what will the environmental benefit be? Will temperatures come down? Will we reduce CO2 emissions in the world? And the answer was no. You know, going it alone is not going to change much. Then soon after that, India and China weighed in, and they basically said, "We are not interested in capping emissions." So we are asking our farmers and ranchers to bear the burden of this when, quite honestly, I would find it very hard to make a claim to them that we are going to see really any environmental benefit.

Second, although there is some debate about the nature and extent of this, it is a given that they are going to have higher input costs. Now, like I said, we can have a great debate as to whether diesel fuel is going to go up X versus Y and this and that, but I think it is a given that they will pay higher input costs.

Now, I put that together with this notion that we have had in agriculture, especially as a result of the 2002 farm bill, that really what we are trying to do with agriculture is take some of the volatility out of it. We talked about the safety net and the loan deficiency program, the marketing loan program, the countercyclical program, the ACRE program. All of those are designed to kick in at a point where we take some of the volatility out of it.

You know, farming is one of those businesses: They cannot pick their price; they cannot predict the weather; they cannot predict what kind of pests they are going to deal with, and on and on. So it is a very, very difficult situation anyway.

Here is what worries me about your piece of this puzzle. I do not think there is anything that we could do that would guarantee that in the trading here that is going to occur that there is not going to be volatility. We might be able to define, to some extent, what the parameters of that are going to be. But it just seems the nature of this that there is going to be volatility.

Now, I think the Ranking Member made some excellent points. As I read the Texas A&M study, there are more losers than winners on this in agriculture. And even in the two farms from Nebraska that they analyzed, those are dryland farmers, and in Nebraska we irrigate. I think they would have been on the losing side of the equation because of higher electricity costs.

So my question to you is: How much should farmers and ranchers be worried about the volatility, the additional volatility that this cap-and-trade legislation is going to put into their lives? And how much does this bill prevent that from happening?

Mr. GENSLER. Senator, I think that you are right, as you said, that farmers and ranchers cannot pick the price, cannot predict the weather, and so forth. I think that what we can do moving forward with Congress is make sure that if you move forward, the trading side is most transparent so the farmers and ranchers can see that pricing; that if they want to hedge it, they can hedge it out a long time; and that the price that they get is created in a market that is free of manipulation and it is fair and orderly. That is our remit at the CFTC, is to make sure that price discovery is fair and orderly, it is transparent, and the farmer can hopefully hedge their risk out, you know, on a yearly or multi-year basis.

Senator JOHANNIS. Here is the difficulty of that if you are a farmer, and I will use the turkey industry as a good example. When corn went to \$6.50, \$7, it wiped out the turkey industry in Nebraska. Just wiped them out. So if you have higher prices and you end up with that kind of situation with higher input costs, it will be zero consolation to that farmer when I call them and say, "I am sorry you went broke because of this thing, but it was transparent." Do you see what I am saying?

Mr. GENSLER. No, I mean, I see what you are saying. I am just addressing what we do well as a market regulator is assuring that there are markets that are not only transparent, but the price discovery function—and this is also for farmers or ranchers that would be having offsets and they wanted to sell those offsets, too, and get the benefit of a price that way as well, as a revenue, that that market is free from manipulation on the trading side of cap-and-trade.

Senator JOHANNIS. Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Johannis.

Let us see. Senator Conrad was next. Senator Gillibrand?

Senator GILLIBRAND. Thank you, Mr. Chairman.

Mr. Gensler, thank you so much for being here. We are extremely grateful for your testimony and your leadership on these issues. I have basically three areas of inquiry that I hope you can address.

The first is about the regulatory structure. I want to know your opinion on whether we should develop a regulatory structure for carbon trading that is distinct from other commodities, or would that, in fact, be more detrimental to the goal of providing effective market regulation and make it more difficult for the CFTC to do their job—enforce position limits, protect against fraud, and other regulatory objectives? So, basically, I would like your opinion on which regulatory structure you think is best and would be most effective?

Second, I want you to address a little bit more specifically about the clearing process. Equity and equity options are handled through an open format, and the multiple exchanges competing for business generally can bring down costs for both clearing and settlement, and it has had that effect over recent years.

Clearing for commodities remains a closed system that lacks any competitive dynamic, and as a result, the costs are higher associated compared to equity and equity options contracts.

So, in your opinion, is it better to create a new model utilizing a noncompetitive model? Or would you prefer to do a more open competition, open access market? Which do you think is more effective, and why?

Then the third issue is a little bit about over-the-counter and customized markets, what you would recommend? If we did have a customized market, an over-the-counter market, what would you recommend for that? And, in particular, do you believe it is appropriate to exempt anyone, particularly end users with bona fide hedges, from the mandate of everything having to go through clearing or an exchange? And do you think it would be appropriate and enforceable to exempt firms with inherent carbon risk—for example, utilities producers—from such a mandate?

So, essentially, do you imagine or would you recommend any trading of customized markets for the carbon exchange that would not necessarily have to go through clearing or not through an exchange rate, depending on what we choose? And then, second, if you do imagine an exception, what kind of regulatory oversight would you imagine? Because, clearly, you would want to have transparency and the regulators would need to know volume. But what would you imagine for the regulatory aspect of that piece?

Mr. GENSLER. Let me see if I can try to address all three of your questions and some of the subparts. It is good to be back with you, Senator.

In terms of regulatory structure, I think that the Commodity Futures Trading Commission does have the expertise and experience, does currently oversee the futures markets, albeit small, in emissions for these out of the acid rain program and even the regional alliance that I think both of our home States are in. So I think that is a good structure. We have two market regulators in this country. I am not sure we need a third market regulator. There is enough that we can harmonize between the SEC and the CFTC.

I think that in terms of clearing you raise a very good point. We have actually recommended for over-the-counter derivatives that we have an open model for clearing. We think that that will promote greater competition amongst exchanges and exchange platforms, and certainly I think it is worthy to think about that in terms of the carbon markets. We would certainly recommend that for the carbon over-the-counter derivatives marketplace, but you raise a question about carbon futures, which is a worthy question. Right now it is a more closed approach on the Chicago Climate Exchange, I believe, but I might be mistaken on that.

Now in terms of over-the-counter markets, I think that it is important to bring as much of the over-the-counter market into centralized clearing and onto exchanges as possible. Some will not be able to be standardized, of course. You raise a second question as

to whether, if there was a hedge that is entered into for accounting purposes, it is a bona fide hedge—I think, if I read into your question, might that be treated a little differently? The administration proposal was to grant the SEC and CFTC some rule-writing authority in that regard to allow some of that to be exempted.

I do have a concern that the more we exempt, the more that we might be years from now looking back at 2009's Enron loophole or something. So I think we have to be very careful in each of these categories in terms of exemptions, because we want end users to manage their risk appropriately, these tens of thousands of end users, but I think society also needs to lower the overall risk by bringing as much into central clearing as possible.

Senator GILLIBRAND. So if there is a customized market left, what would you have it look like? And who would be eligible—

Mr. GENSLER. Well, I think there will be a customized market, both in carbon markets as well as interest rate products and elsewhere. But I think the dealers in those markets have to be fully regulated so that the customized transactions and the standard transactions, the dealers would have to have capital; there would be business conduct to protect against fraud and manipulation so we could police the markets along with the SEC on the other products. These products would probably be more ours, oversight, and then the transparency, that not only as regulators we saw it, but we could aggregate the data and put it out to the public.

Senator GILLIBRAND. Thank you.

Chairman HARKIN. Thank you, Senator Gillibrand.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, and thanks for holding the hearing today. Welcome, Chairman Gensler. We are glad you are back.

Mr. GENSLER. Good to see you again.

Senator LINCOLN. I would like to associate my comments with the Senator from Pennsylvania, Senator Casey, in terms of the challenges that we face, but the opportunities that we can find there. And I think there are great opportunities here.

I also want to associate my comments with him in terms of making sure that as we do move forward, we do not do so putting a disproportionate burden on our hard-working farm families and our agricultural communities across this country. They do a tremendous job providing food and fiber for the world, and I hope that as we look at what we are trying to do, we will keep that in mind always.

While it is not necessarily my preference to move on cap-and-trade legislation in the Senate this year, if the Senate is going to move on climate change legislation in the future, certainly the regulation of carbon markets is something that we have to get right. And we are certainly going to need you all at CFTC to help us do that, Mr. Chairman.

Under the cap-and-trade legislation, we are venturing to create kind of a whole new commodities market which presents, I think, a number of these challenges that we talk about and issues for Congress. And we thank you for your hard work in this area and the research you have already done in working to try and come up with those solutions.

Just a couple of questions for the Chairman. Obviously, CFTC could play such a large role, as you have mentioned, and has the capability to do that in regulating carbon markets under a cap-and-trade system. What would you say is probably the most important thing that you have learned or that we, all of America, should have learned or could have learned from the EU experience in regulating the carbon market?

Mr. GENSLER. I think that what we have learned from the European experience is these markets are going to be likely sizable, that we have to bring transparency to these markets, that they need to be regulated. They do not yet regulate the over-the-counter derivatives marketplace, and I cannot point to a problem there, but I think enough problems have been in our markets that we should include the carbon markets in what Congress is moving forward in over-the-counter derivatives for sure. But I think transparency and to make sure that we bring it under market regulation, any centralized cash market, any centralized futures market, and also this over-the-counter market.

Senator LINCOLN. Will you continue to, I think, certainly re-emphasize the fact that what we have done in the past here in similar situations has been on a much, much smaller scale when we talk about—you have mentioned the SO₂ and the SOX and the NOX and what we have dealt with there. Do you think what we are dealing with here is too large to deal with, with this type of an approach?

Mr. GENSLER. No, I do not. I think it is just a larger scale. The size of it makes it even more incumbent upon us that we have an oversight function, that the price discovery function is free of manipulation, and that it is transparent; that a national registry, even if it is kept by EPA, is updated on a very regular, real-time basis—not at the end of the month, not at the end of the quarter, but it is really updated on a very regular basis and so forth.

Senator LINCOLN. Well, I have some real concerns about the volatility or the possible volatility in these new markets, carbon markets. And I guess the two questions I would have to you on that would be if you believe that the Waxman-Markey approach is the correct approach to helping prevent carbon markets from wildly fluctuating, what do we see in the possibility of the ramifications of that volatility, that possible volatility, particularly to consumers?

I know Senator Johanns brings up his turkey farmers. I have got a lot of poultry farmers and catfish farmers and others that exactly what happens, cattlemen as well, when the price of that feed goes up, they are out of business. And when they do, then the price of those products, those foods in the grocery stores go up. There is concern all around.

What about that volatility? Do you think the Waxman-Markey approach has enough in it to deal with that volatility? And how do you think that volatility could affect our consumers?

Mr. GENSLER. I think that as Congress tries to address itself to how to lower the emission of greenhouse gases, the trading piece of this, it is most important to make sure there is transparency. Like other markets, there will be some volatility, but the way one addresses that volatility is to make sure that people can hedge their risk for long periods of time, that they are not subject to the

whims of a current weather pattern or some weekly pattern and they can hedge it; they can see that national pricing, they are not subject just to some dark market; and that you have a strong regulator who is going to enforce manipulation standards and aggregate position limits as we seek to do in other markets.

But you are right, and both Senators are right. I mean, there will be some volatility in this marketplace, but I think transparency, anti-manipulation, a national market rather than smaller regional markets, and aggregate position limits are a part of the puzzle here.

Senator LINCOLN. Thank you.

Thank you, Mr. Chairman.

Chairman HARKIN. Thank you, Senator Lincoln.

Again, Chairman Gensler, thank you very much for your testimony and for your leadership at the Commodity Futures Trading Commission. I listened as intently as I could to a lot of the questions. Some of those were kind of policy questions and things like that, but we just need to have you keep in close contact with us on resources that are needed and how we structure the oversight and regulatory regime for this so that it functions well.

I leave you with where I started and, that is, my concerns again about speculation on derivatives and how that might artificially jack up the prices on these allowances and offsets and not in accordance with really what they should be worth. I asked that question at the beginning, and I still have concerns about it, but this would be an ongoing dialog and discussion, I am sure.

Mr. GENSLER. Thank you, Mr. Chairman, members of the Committee, and we are available to be of help at any time.

Chairman HARKIN. I appreciate it very much. Thank you very much, Chairman Gensler.

Mr. GENSLER. Thank you.

Chairman HARKIN. We will call our next panel up: Mr. Timothy Profeta, Director of the Nicholas Institute for Environmental Policy Solutions at Duke University; Mr. Joseph R. Glace, I believe—I hope I pronounced that right—Vice President for Risk Management and Chief Risk Officer, Exelon Corporation; Dr. Dave Miller, Chief Science Officer, AgraGate, and Research & Commodity Services Director for the Iowa Farm Bureau; and Ms. Julie Winkler, Managing Director, Research and Product Development, CME Group, and Member of the Board of Directors of the Green Exchange Venture.

Mr. Glace, did I pronounce your name correctly?

Mr. GLACE. Yes, sir.

Chairman HARKIN. OK, good.

Senator CASEY. Mr. Chairman, Mr. Glace also has Pennsylvania educational roots. Am I correct?

Mr. GLACE. Yes, sir.

Chairman HARKIN. What is this, Pennsylvania Day here? Or what is going on here?

Senator CASEY. We are just going to keep that commercial going. Thank you.

[Laughter.]

Chairman HARKIN. We have Pennsylvania on the next panel, too. Pennsylvania Day here.

Well, welcome to all of you again. You can tell from Mr. Gensler's testimony and our questions that there is a lot of interest in this Committee on how this is not only structured, but how it is regulated. This panel basically will continue our discussion on how we regulate carbon markets in a cap-and-trade system. Our next panel will be from the producer group perspectives, but I understand that a lot of this stuff flows back and forth, and we might get into some producer things also here on the regulatory panel.

As I said in the beginning, your statements will be made part of the record in their entirety. I would ask you to sum up in 6 minutes or less what your main point is so we can get to discussions with you on those points.

I would start first with Mr. Timothy Profeta, Director of the Nicholas Institute for Environmental Policy Solutions, and not a stranger here to the U.S. Senate.

STATEMENT OF TIMOTHY PROFETA, DIRECTOR, NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS, DUKE UNIVERSITY, DURHAM, NORTH CAROLINA

Mr. PROFETA. Thank you, Mr. Chairman. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify today. Right now I wish I went to school in Pennsylvania, but it is an honor to be here.

My testimony today is focused on the issues and concerns regarding the design of the carbon market. Given the financial market failures in recent years, however, it is understandable that a market approach should not be viewed as a foregone conclusion. However, I want to submit at the outset that, in our institute's evaluation of a number of policy options, the market remains the best means to achieve the environmental goals at the lowest cost.

Almost by definition, private actors with a market incentive will find a lower, less costly alternative to reduce greenhouse gas emissions than the Government could determine by fiat. And cost, in the end, is the determining factor. No sector is more aware of this than the agricultural sector. And as one more aside, let me note that the institute this week released a report co-authored by our colleagues at Texas A&M and Oregon State and EPRI to try and put an end to the "he said, she said" debate over agricultural impacts. At bottom, our study found that the net flow of greenhouse gas revenue and indirect commodity market revenues for farmers still outweighed the increased operating costs that we did see from the climate program.

Much of the market's cost-reducing benefits, however, could be weakened if the market does not operate transparently and efficiently. We know all too well that imperfect markets occur. Recent market failures provide a number of lessons, however, that you can apply to the creation of a new carbon market, including the importance of market transparency, vigilant regulators with adequate resources and jurisdiction, and effective risk management.

But before I recommend how these lessons should apply to the carbon market, let me first point out its uniqueness. Carbon will be unlike other commodity markets. It is an especially important point right now as the question of a carbon market is becoming complicated for fear that it will be a proxy for greater commodities

regulation. I would like to point out a few distinguishing aspects of the market.

First, unlike other commodities markets, the entire carbon market is created by the Government to achieve a societal goal. Demand for the product, and the product itself, is created by Government action, and thus the Government has a special duty to ensure that the market operates effectively.

Second, entities covered by the legislation will have no choice but to participate in the market, and it is a market with an ever reducing supply.

Third, the carbon market is likely to be driven heavily by derivatives, underscoring the need to design an appropriate regulatory structure. In particular, climate legislation will likely create a long-term, 38-year obligation for regulated entities, and these entities will need access to financial instruments to hedge their exposure through derivatives—a necessary element to securing investment for new, low-carbon-emitting energy technologies.

I would like to leave you today with four principles for an effective carbon market based on the lessons of the past decade: one, real-time transparency; two, adequate risk management and settlement; three, a vigilant and well-funded regulator; and, four, transparent data and strong quality controls on the allowances traded.

First, transparency. To the extent that instruments are traded on registered exchanges, the exchange member's activity will be "printed" on the exchange providing for the needed transparent information. If OTC transactions are to take place in the carbon market, the legislation will need to ensure that the regulator, market participants, and the general public have sufficient data to oversee and evaluate trading activity.

Finally, Congress will need to balance the public's access to timely market information with the legitimate concern that covered entities may need to protect their confidential business information. In addition to the information made available to the general public, regulators should have access to the full range of market activity in real time in order to prevent and punish market abuses, including fraud and manipulation. The obligation should lie with the market participant to provide the information to the regulator, not the other way around.

Current market participants also need to know that the allowance purchased on the spot, forward, and futures markets, which are held to maturity, will be delivered. In regulated financial markets, counterparty risk is generally managed by clearing the transactions. If the Committee wants to minimize the risk from counterparty failure, as much trading should occur on exchanges, or at least be cleared centrally, as is feasible.

Many will contend that clearing of long-term structural contracts will be difficult, as such transactions are unique and not liquid, and that parties will be required to post the collateral, or margin, necessary to participate in the market. These are non-trivial issues and pose a choice between mitigating systemic risk and creating the additional cost of posting margin.

It is important to note that market participants pay for the risk or risk management somehow, either through the posting of mar-

gin or through the pricing of OTC instruments. It will be your role to evaluate that tradeoff.

In the case that Congress provides exceptions to cleared or exchange-traded transactions, transparency for the counterparties and the regulator is even more important.

Access to market data should be coupled with sufficient resources to process and analyze the information, broad jurisdiction that allows the regulator to oversee any trading that involves allowance-based financial instruments, and appropriate enforcement authority. If Congress will ask the CFTC to take on the oversight of this new market, then more resources will be required to build the team of regulators needed.

Finally, the Government must ensure that the information regarding emissions is transparent, predictable and reliable. It must predictably produce information about the Nation's emissions to allow the market to evaluate the demand. A good example of an effective program has been the U.S. Acid Rain cap-and-trade program.

The Government also must provide the market with adequate assurances that the products traded in the carbon market are what they claim to be. With regard to the emissions allowances, the Government will create, serialize and track the Government-issued right to emit.

With regard to offset credits, however, the Government's role is to provide adequate protocols and procedures to ensure the market that any carbon offset project is real and verified.

The market is a powerful tool, by which environmental objectives may be achieved at historically low costs. Concerns about market abuses have, nonetheless, led some to conclude that now is not the time to create a new market. Let me posit that the exact opposite is true. If you choose to create a market, now is the best time to create a transparent, effective market that prevents excessive speculation and manipulation. The lessons are clear, and the public is attuned to the needs. If it wants to do so, Congress has the tools it needs to create a well-functioning marketplace.

Thank you, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Profeta can be found on page 106 in the appendix.]

Chairman HARKIN. Thank you, Mr. Profeta.

Now we will turn to Joseph Glace, Vice President for Risk Management, Exelon Corporation. Welcome, Mr. Glace.

STATEMENT OF JOSEPH R. GLACE, VICE PRESIDENT FOR RISK MANAGEMENT AND CHIEF RISK OFFICER, EXELON CORPORATION, CHICAGO, ILLINOIS

Mr. GLACE. Good morning and thank you for inviting me to testify this morning. It is truly an honor to be here today.

My name is Joe Glace, Vice President and Chief Risk Officer of Exelon Corporation. Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, ComEd and PECO, serve 5.4 million customers, or about 12 million people—more than any other company in the United States. We have fossil, hydro, nuclear, and renewable generation facilities. Our nuclear fleet is the largest in the Nation and the third largest in

the world. I have worked in the energy field for over 29 years. At Exelon, I am responsible for leading the risk management function, including the identification, assessment, and monitoring of market, credit, and operational risks.

In my testimony today I would like to highlight the following: Exelon's support for comprehensive climate legislation; Exelon's opposition to requiring all trading, derivatives, and hedging activities to be conducted on exchanges; Exelon's support for expanding the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter market; and Exelon's support for the reporting requirements for OTC transactions in the carbon markets.

Exelon was an early and vocal advocate of climate change legislation. Our CEO, John Rowe, first testified in favor of addressing climate change by means of a carbon tax in 1992. We are pleased that the House has passed a comprehensive climate and energy bill and look forward to working with the Committee and the Senate to pass comprehensive, cap-and-trade legislation this year.

Exelon supports a bill with realistic targets and an effective cost containment mechanism, such as a cost collar, and allocating allowances to regulated local utilities with a requirement that the value represented by those allowances be used to provide benefits to customers.

I think it is important to explain briefly Exelon's overall approach to commodities trading. We are not speculators. We use commodities trading primarily to reduce price risk from spot market power prices. Our business model is to lock in, or hedge, the price we are paid for the electricity we generate.

We do this by buying and selling energy products in the markets that are available. For example, we might sell electricity at an agreed-to price for all hours in the summer months of June through September. We also might transact in the over-the-counter market for coal to lock in our fuel cost.

Our customers benefit from this hedging and trading activity. We are in a position to agree to longer-term power sales contracts with both wholesale and retail customers. It is our experience that retail customers, in particular, want stable power prices. Without hedging and trading, that simply would not be possible.

One of the principal concerns many have expressed with adopting a carbon control regime is how it will affect our fragile economy. Simply put, a properly regulated, robust trading program, plus liquid trading markets, will help control the overall cost of the program.

It is important to view the issues before this Committee from the customer's perspective. What steps should the Congress take to regulate carbon trading emissions without imposing undue costs on consumers? Our strongly held view is that any regulatory reform of the commodities markets should ensure that the products which we use to hedge our risks remain available to us and at a cost that is comparable to the costs we face today. We believe it would be a mistake to force most, if not all, derivative hedging activities to exchange-traded platforms.

Today, a substantial component of our derivatives hedging program is in the OTC market without clearing. Transacting on ex-

changes is much more expensive than in the over-the-counter markets because it requires posting of substantial amounts of cash as collateral. This is one reason we do not—in fact, cannot—conduct all of our hedging activity on exchanges. Moving all our hedging to exchanges would require substantially larger cash outlays. This in turn would mean our customers would have to pay substantially more for electricity.

Another drawback of limiting hedging activity to exchanges is that these entities only offer a standardized set of products. Exelon often enters into customized transactions that mitigate the particular risk we are trying to hedge than would one of the exchange-traded standard products. To draw the obvious conclusion, power prices will be higher, meaning consumers will ultimately pay more than they would otherwise, if companies like Exelon are forced to do all of their hedging on exchanges.

I will now turn to the question at hand: what to do about the coming market for carbon emissions allowances. The cost of carbon allowances will be a cost of doing business for generators. It will be just like the cost of natural gas, oil, or coal—an input that is necessary to enable us to make and sell our product. Exelon will need to hedge the price risk associated with that product. Exelon will want to have both exchange-traded and over-the-counter offerings that now exist to manage these risks.

We recognize, however, that there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps. That is why we support the expansion of the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter market. This should allay any concern that any trader could artificially drive prices up.

The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to the OTC markets and perhaps revised and refined to ensure that they provide to the CFTC the tools it needs to prevent manipulation.

For the same reason, Exelon also supports the adoption of new reporting requirements for OTC transactions in the market for carbon allowances. The CFTC has to have access to information about transactions to enable it to fulfill its regulatory oversight and enforcement function. Also, the obligation to report, as such, will be a powerful deterrent to would-be manipulators.

I appreciate the Committee's invitation to testify today. This is a complicated subject area. I hope that I have provided you with a sense of why it is important to ensure that there is effective oversight of the emerging carbon markets while at the same time guarding against over-regulation that would result in higher costs for companies like Exelon and in turn for our customers.

I would be pleased to answer any questions you may have this morning. Thank you.

[The prepared statement of Mr. Glace can be found on page 81 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Glace.

Now we will turn to Mr. Dave Miller, Chief Science Officer for AgraGate, and Iowa Farm Bureau. Welcome, Dr. Miller.

**STATEMENT OF DAVID MILLER, CHIEF SCIENCE OFFICER,
AGRAGATE, AND RESEARCH & COMMODITY SERVICES DI-
RECTOR, IOWA FARM BUREAU FEDERATION, WEST DES
MOINES, IOWA**

Mr. MILLER. Thank you very much for this opportunity to discuss issues regarding market structure and market performance as it pertains to carbon markets. My name is David Miller, and in addition to the activities and services working with the Iowa Farm Bureau and AgraGate, I also farm. On our 400-acre farm in southern Iowa, we converted to continuous no-till in order to qualify to earn carbon credits under CCX rules. I am one of thousands of U.S. farmers who work more than 16 million acres that have been paid for providing environmental services through the CCX enrollment and carbon services. While I have served for over 6 years on various governing committees at CCX, I am speaking today on behalf of AgraGate and the Iowa Farm Bureau.

Occasionally, we have been asked why all of the credit registrations we have done through AgraGate have been on the Chicago Climate Exchange, and the simple answer is that the CCX has the only protocols that are workable for production agriculture and private forestry. Market design and structure matter and are critical to market performance. Some of the items that I would like to discuss today include market transparency, offset protocol standards, and the critical need for fungibility of compliance offsets. And I apologize to the Committee for getting down into the weeds on some of these things, but as a farmer, I know if I do not take care of the weeds, there is no crop.

Market transparency is critical to smooth operation of a carbon market. Transparency means that not only must there be a clear enumeration of what criteria are used to define offsets, but that there must be a mechanism in place so that prices—bids, offers, and sales transactions—are publicly reported and readily available. The only market in the offset market that currently offers that transparency is the Chicago Climate Exchange. Unfortunately, that pricing transparency has been sharply curtailed. Under the provisions of H.R. 2454, there is language that suggests that domestic offsets from current registries may be exchanged or recognized in the Federal regulatory program, but not allowances or international offsets. This has resulted in all offset transactions moving to the bilateral, privately negotiated trades where the buyer can be assured that they will receive offsets rather than the other compliance instrument as might be the case on the electronic platform.

To improve transparency, CCX rules have been updated to require that all these privately negotiated trades be reported. But the bid-ask spread has widened significantly, and the market has fragmented. This has increased the transaction costs associated with carbon marketing and has reduced the net returns to the actual offset providers.

Regulatory uncertainty is now harming the thousands of farmers and companies who have taken the lead in building these rules-based carbon markets, and it is extremely important that we provide a smooth transition for those who are making emissions reductions today in CCX and other verified programs.

With regard to fungibility, the fungibility of compliance offsets is extremely important, where a registered offset credit equals a registered offset credit regardless of the source of the credit. It is a market design characteristic that is essential if the transaction costs of the carbon market are to be minimized.

“Term Credits,” as delineated in H.R. 2454, are not fungible compliance instruments. They only delay compliance obligations. They do not satisfy them. They are an inferior product, and based on the experience of temporary credits under the European trading system, they will have little or no value. It is extremely problematic that H.R. 2454 has relegated all soil sequestration offsets, by design, to the class of term credits. It is neither necessary nor desirable from a market design perspective to address the issue of permanence in this manner.

Design criteria for offset protocols can make or break the viability of agricultural and forestry offsets as real tools in the efforts to reduce atmospheric carbon. To be viable, offsets must be designed for “working lands.” And to be a workable part of the solution, the carbon offset protocols must work within the framework of existing agricultural markets. Length of contract matters. In Iowa, more than 60 percent of the farmland is rented by the operator with the vast majority of that land on 1-year renewable leases. In our experience of working with farmers on carbon offsets, the No. 1 reason why a farmer would not participate in a carbon offset program is the length of contract.

We have looked at the proposed protocols of other registries. Some of these protocols have single-term length commitments anywhere from 20 years to 199 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long.

Generalized quantification methodologies are a very effective and low-cost way to quantify soil sequestration offsets. But do not be fooled by the “illusion of accuracy” that some would say exists when credits are granted based on-site-specific soil sampling. And there is more in my statement about that, but for time, I will leave that to the written.

I would like to address some of the market regulatory framework. As is being demonstrated by the early action programs, carbon can and is becoming a commodity that can and will be traded just like other commodities. The experience of the Chicago Climate Exchange is proving that markets for carbon can and do work. The actual registry and retirement of allowances and offsets should be done on regulated, open, transparent markets with specific standards for price reporting that include date of transaction, vintage, quantity, and price information.

The CFTC should continue in its role as the regulator of derivatives, futures, and options contracts associated with carbon trading, and Farm Bureau opposes the efforts to combine CFTC and the Securities and Exchange Commission and supports regulation of the commodity futures business by CFTC. Derivatives, futures, and options on carbon contracts are not fundamentally different than other derivatives, futures, or other markets. The oversight provided by the CFTC can be adequate for those markets.

In my written testimony, I also talk about some of the capital and margin requirements. Leverage is important, and I think we need to pay attention to those.

I would finish by saying that USDA has a distinct and unique role as part of the administration of offsets, and that is a unique part of also the regulatory structure.

I thank you for the opportunity to be a part of this, and I stand ready for any questions.

[The prepared statement of Mr. Miller can be found on page 90 in the appendix.]

Chairman HARKIN. Dr. Miller, thank you very much for your statement, both here and the written statement.

Now Ms. Julie Winkler, Managing Director, Research and Product Development for the CME Group, and member of the Board of Directors of the Green Exchange Venture, and since everybody is bragging about Pennsylvania, I am told you really came from Waterloo, Iowa. I want to state that for the record.

Ms. WINKLER. That is correct.

Chairman HARKIN. Thank you. Ms. Winkler, please proceed.

STATEMENT OF JULIE WINKLER, MANAGING DIRECTOR, RESEARCH AND PRODUCT DEVELOPMENT, CME GROUP, AND MEMBER, BOARD OF DIRECTORS, GREEN EXCHANGE VENTURE, CHICAGO, ILLINOIS

Ms. WINKLER. Mr. Chairman, members of the Committee, I am Julie Winkler, Managing Director of Research and Product Development of CME Group Inc. and a member of the Board of Directors of the Green Exchange LLC. Thank you for the opportunity to appear before the Committee today and provide our views regarding the regulation of a U.S. carbon market.

The Green Exchange Venture believes that cap-and-trade is the preferred solution for guaranteeing emissions reductions at the lowest possible cost to the economy. In order for the promise of a cap-and-trade program to be met, it must be built on certain design principles.

First, we strongly support providing compliance entities with a choice of utilizing exchange-traded derivatives and OTC instruments to meet their environmental obligations. Also, in order to provide these customers with effective risk management tools and liquidity, the U.S. carbon markets must allow for broad market participation. We further believe that the Commodity Futures Trading Commission is best suited as the regulator of the U.S. carbon marketplace. Last, to ensure the creation of a transparent U.S. carbon market with the necessary liquidity and price discovery they provide, regulatory proposals should not include a transaction tax.

CME Group is one of six founding members of the Green Exchange Venture, which is currently comprised of 13 partner firms from the energy, environment, and financial sectors. CME Group currently provides the electronic trading platform, central counterparty clearing services, and other exchange services. Our partners are currently major participants in the European carbon markets as well as regional environmental markets.

We strongly believe that a cap-and-trade program offers the best opportunity to minimize the cost of mandatory reductions in greenhouse gas emissions. Emissions trading systems are already operating or planned in over 35 countries, and they have proven that cap-and-trade programs can successfully cut emissions with efficiency and cost-effectiveness.

There are several design features that are critical to a well-functioning cap-and-trade system and related derivatives markets. Based on our extensive market development experience, we strongly believe that a cap-and-trade system must include participation beyond compliance entities.

Futures markets perform two essential functions: they create a transparent venue for price discovery, and they permit low-cost hedging of risk. And to be effective, futures markets depend on a broad universe of market participants with both short-and long-term expectations to make markets and provide liquidity.

We also believe that imposed price floors or ceilings should be avoided if a carbon market is to create meaningful price discovery. Price caps reflect factors extraneous to the fundamental factors that drive prices and, thus, are not connected to actual supply and demand.

While it may seem that artificially constraining prices with a ceiling will reduce price volatility or market manipulation, the opposite is likely to result.

We fully understand the motivation to protect American consumers from dramatic increases in the cost of carbon. However, we believe this can be facilitated through strong market oversight and not through price floors and ceilings.

By offering electronic trading of exchange-traded carbon derivatives, coupled with a comprehensive clearing solution, we will enhance price discovery, contribute significantly to liquidity, and reduce risk and uncertainty for market participants. CME Clearing is one of the largest central counterparty clearing services in the world and has provided clearing services for the futures industry for over a century without a single customer default.

Electronic trading and clearing solutions also provide a trustworthy and timely audit trail to effectively identify anyone who engages in misconduct. We believe that because of the CFTC's established expertise and coordination with the global derivatives industry, it is in the best position to provide strong regulatory oversight to the carbon markets.

We applaud the efforts of this Committee and the administration to ensure that a mandatory U.S. cap-and-trade program will enhance transparency, integrity, efficiency, and fairness in the markets. As beneficial as exchanges and clearinghouses will be in a U.S. carbon market, they will not meet all the needs of customers. Although the Green Exchange Venture and other emissions trading platforms would likely be the presumed beneficiaries if all transactions were required to be executed on electronic trading platforms, we do not believe this would be in the best interest of a U.S. cap-and-trade program.

Exchange-traded and OTC derivatives markets are essential to the efficient functioning of a U.S. carbon market. Together, these markets can provide compliance entities with the ability to increase

their certainty in their future cash-flows by protecting against price risk and effectively managing their capital, thereby increasing their ability to meet compliance obligations at the lowest possible cost.

The OTC market is complementary to standardized exchange-traded products by providing products customized to a regulated entity's emissions and their time horizon. While some types of customized transactions must be conducted OTC, the remainder of carbon transactions that we envision will likely lend themselves to exchange-traded products.

While OTC transactions should be present for a cap-and-trade program to be fully successful, the OTC carbon market must provide a greater level of transparency than what is currently present in other OTC markets. As part of its special call reporting, the CFTC already requires extensive reporting of OTC commodity derivative positions. This reporting framework can be leveraged and extended to include new carbon derivatives. Entities such as the Green Exchange Venture will provide capped entities and other market participants with the venue to safely and securely manage their carbon price risks.

Regulated exchanges, clearing solutions, and the CFTC will ensure a high level of transparency to the U.S. carbon markets. This strong regulatory structure combined with added transparency in the OTC market will enable compliance entities to meet their environmental obligations and allow agricultural and forestry offset developers to fully participate in a well-functioning U.S. carbon market.

I appreciate this opportunity to offer these comments to the Committee and will be pleased to respond to any questions.

[The prepared statement of Ms. Winkler can be found on page 121 in the appendix.]

Chairman HARKIN. Thank you very much, Ms. Winkler, for your testimony. Thank you to our entire panel.

Mr. Profeta, are there any reasons why the success of a cap-and-trade approach in reducing sulfur dioxide emissions under the Clean Air Act cannot be replicated here for reducing greenhouse gas emissions? What have we learned from the European market? And why can't we just replicate that here? Is that something that we could do?

Mr. PROFETA. Well, Mr. Chairman, I think the first foremost lesson is yes, both of those experiences have taught us that the market does work. The acid rain trading program somewhat famously came in at about 20 to 30 percent of the cost estimated, what was estimated when the legislation was passed. We found in the EU that the market works as well.

There are distinctions here in terms of this greenhouse gas market that might be created by Congress and those markets that have—I think the universal opinion on this panel would be that there might be greater oversight and need a comprehensive regulatory program at the outset.

The acid rain program is a different scope and scale and not nearly as driven, likely to be driven to the derivatives as this long-term market would. And the EU market as well, the cost was somewhat mitigated by some of the distinctive features in the EU market and has actually started to gravitate toward exchanges.

Now about 50 percent are on an exchange, and, of course, the EU market also, being short term, does not have the long-term requirement of the emitters that this would have.

So both those teach us a lesson that the markets can work and also there can be distinguishes not in need of regulatory oversight as this one.

Chairman HARKIN. I also want to note that in your written testimony, you mentioned as an aside the study that was co-authored by several leading agricultural economists. You said it found that “the net flow of greenhouse gas revenue and indirect commodity market revenues for farmers far outweigh the increased operating costs.” It says “benefits to crop and livestock producers far outweigh these economic losses”—to consumers and agricultural processors—“signaling gains to the sector as a whole. If done the right way, agriculture can be made a winner in climate legislation.”

I assume, though, that there are some sectors within agriculture that will do better than others. Is that right?

Mr. PROFETA. Absolutely true. There will be ebbs and flows in the system, and some sectors and some farmers will do better than others. I think in general we have found there were higher input costs but higher output costs as well, a modest consumer response, increased bioenergy supply, and offset income opportunities. And the key feature, the main benefit to the farmers that really come through in these modeling runs come through indirect commodity market shifts that drive up crop prices and revenues. So that is not seen in some of the other studies, and I should note that in doing that we reached out to our colleagues at places like Texas A&M and Oregon State to try and bring together a team that could get after the “he said, she said” that has been happening in terms of the agricultural economics of climate.

Chairman HARKIN. Mr. Glace, do you believe a price collar a floor and ceiling would bring about desired certainty in terms of controlling risks and volatility? How do you feel generally about a price collar?

Mr. GLACE. Exelon advocates the use of a price collar. The main reason is to protect customers from higher prices in the early transition period for this program, if you will. We think that it is very important to protect customers from being impacted by higher prices, and we think that is the primary use of the collar. In any risk management situation, if you are afraid of volatility and uncertainty, it is nice to have options. Collars and floors help band in some of the risk, and these are the tools in the bag that we all use routinely to manage risks.

Chairman HARKIN. I want to turn now to Dr. Miller and Ms. Winkler. I have only got a minute left here, but back to the issue of derivatives and swaps and the over-the-counter market, Ms. Winkler is basically praising and is in favor of that. Dr. Miller, you raised some questions about it.

As I understand, Ms. Winkler, you are saying that we need this to get financing for offset projects. Well, that may be one way, but aren't there other ways such as forward contracting, traditional bank lending, or guaranteed USDA loans that could also ensure offset projects get financed rather than just through a derivatives?

I am concerned about this view that we must have customization, especially when compliance obligations are measured in standard government-issued allowances due each April 1st. Given that do we really need customization? I am still searching for that answer. Ms. Winkler?

Ms. WINKLER. Yes, Chairman, I think the best example would be my fellow panelist Joe Glace talking about the needs for him to have the flexibility to have both customized transactions in the over-the-counter market in addition to the standardized exchange-traded products that he uses. So while financing is certainly one reason why people would use over-the-counter instruments, it is not the only reason. You know, some of the other things is that it can help an emitter specify the actual emissions that they are offsetting against and hedging against, and also being able to customize it to the time horizon that they are most concerned about.

Also, as Joe pointed out, you know, for some entities it becomes more difficult to be able to post that collateral with the exchange in terms of the margin requirements, and with the role of an exchange and a clearinghouse, we are providing mark-to-market and settlement values on a daily basis, which could at times, with price movements, require substantial dollars to be moved in and out of the clearinghouse.

Chairman HARKIN. Dr. Miller, do you have any observations? My time is—

Mr. MILLER. Yes, I think one of the great issues is transparency of the over-the-counter market, and you can gather and get additional transparency with reporting. We do reporting of the cash grain markets. We do not report every individual transaction, and we do not report who was at the transactions, but we do report the prices and we do report where those things were happening. And that gives sufficient transparency to that system that it functions well, and that is partly what is missing in the current over-the-counter markets.

Chairman HARKIN. Got it. Thank you.

Senator Chambliss?

Senator CHAMBLISS. So, Dr. Miller, if we went to a system where there was complete transparency and the reporting of those contracts that were traded over the counter, would that address the concerns that you have about OTC?

Mr. MILLER. To a large degree, I think it would, particularly as it would apply to the compliance instrument itself. The actual offsets or allowances are going to be registered products that are standard products because they are a compliance instrument. And right now in the voluntary market, the only exchange that is doing broad-based price reporting is Chicago. The other exchanges, I went out and looked, and I cannot find reported prices for the Climate Action Registry. I cannot find reported prices. I can for the futures markets that are regulated, but for the spot markets on a number of these other projects and CDM projects, there is no price reporting. There is no transparency.

The associated issue that is connected with that, though, is leverage, and one of the problems that was part of the debacle, if we would say, that occurred in the financial markets with regard to credit default swaps, et cetera, was not only a transparency issue

but a leverage issue. And, yes, there is cost to doing margining and things on exchanges, but the exchanges did not have any defaults, the exchanges did not have those problems because there were limits to the amount of leverage that could be put to those type of derivatives.

Senator CHAMBLISS. Well, Ms. Winkler, if we develop a system that requires transparency of all trades, whether they are standardized trades or whether they are more tailored transactions, which I assume we could devise some system to do that, would that interrupt the market in any way, in your opinion?

Ms. WINKLER. Senator, we are very much in support of full transparency of the marketplace, and, you know, our goal as operating an exchange and a clearinghouse is being able to serve as the price discovery vehicle for what carbon is in the U.S. And I believe through our existing infrastructure and also the audit trail that our electronic trading system and our clearing system can provide, in the close coordination we have with the CFTC, we are going to be able to easily accommodate that additional transparency that is going to be needed.

Senator CHAMBLISS. Mr. Glace, would your ability to enter into financially settled swaps for electricity such as the example outlined in your testimony be hindered or become more expensive under the recent proposal put forward by the administration for regulating over-the-counter derivatives?

Mr. GLACE. Yes, sir. We believe that, again, a lot of the forcing to organize the exchanges would seriously reduce the amount of hedging that would be able to be done in the marketplace because of the fact of all the initial cash that has to be put up to support the transactions.

Senator CHAMBLISS. And who is going to pay for that ultimately?

Mr. GLACE. Ultimately, consumers pay for this additional—any additional cost that enters the system ultimately finds its way into the price to the consumer.

Senator CHAMBLISS. Yes. Well, in talking about the transparency issue, which I think is going to be the focus of the debate when we get to this financial system overhaul issue, I assume you have no issue with transparency.

Mr. GLACE. No, sir.

Senator CHAMBLISS. You are not trying to hide anything or do any secret deal out there. So is there a way, in your mind, that we could develop a system that would provide full transparency and allow you to operate in the market with tailored transactions like you sometimes do today?

Mr. GLACE. Absolutely. Exelon supports expanding the CFTC's jurisdiction and expanding the CFTC's ability to gather reporting and transactional information to assess positions. And we believe in rigorous oversight in the markets and full transparency.

Senator CHAMBLISS. Mr. Profeta, let me ask you to comment on that same question. You encourage, obviously, the clearing of all transactions "as is feasible," I think is the way you put it in your testimony. I think that has been stated an awful lot and with different wording by different experts in this field. But is there a way to take tailored transactions, in your opinion, and whether you call

them standardized or not, effect total transparency in the marketplace?

Mr. PROFETA. I think the most important thing is to make it transparent to the regulator, and I think it is possible to do that in much the way my co-panelists have described here. The best way to control for the risk is to build it into the system so you do not get to the point where to regulate it is to see it. But there are distinct, long-term structured deals that it appears cannot be standardized and put—cleared. And if it is open and apparent to the regulator, I think we can control for a lot of the risk that way.

Senator CHAMBLISS. What do you think would be the biggest hurdle in having a tailored product transparent to the regulator? Or is there a hurdle out there?

Mr. PROFETA. I think it is just a matter of establishing the correct authority for the regulator to receive that information. As I suggested in my testimony, it may be appropriate to put the obligation on the transacting parties to give the information to the regulator rather than putting the obligation on the regulator to make sure that the data gets to the CFTC.

Senator CHAMBLISS. Mr. Chairman, I know I am over my time, but let me follow up. Mr. Glace, is there a problem from your standpoint as a participant in these contracts in the marketplace in providing the regulator with full disclosure of what the transaction that you have entered into from the hedge standpoint is all about?

Mr. GLACE. No, sir. Full disclosure is not a problem.

Senator CHAMBLISS. OK. Thank you.

Chairman HARKIN. Thank you, Senator Chambliss.

Let us see now. Senator Johanns?

Senator JOHANNNS. Mr. Profeta, let me get started with you. I think in response to some questions, you have acknowledged that for farmers there is going to be higher input costs, and I think virtually every study shows that. Is that something we agree upon, input costs will go up?

Mr. PROFETA. Yes, input costs will go up. Fertilizer costs may be controlled by provisions to help that industry, but input costs will go up, yes.

Senator JOHANNNS. And I think the fertilizer business would debate you on that one. They seem to believe their costs are going to go up also.

Mr. PROFETA. I have said the word “may” cautiously because I have no idea what the Senate’s policy will be on that and how it will be affecting the industry. But there are efforts at least to try and hold that sector of the industry harmless.

Senator JOHANNNS. Now, as I understand the Texas A&M study—and, again, by inference from your testimony, it appears that you are reaching much the same conclusion—it is not the credits or allowances or whatever that is really going to help the farmer out to deal with those input costs. It is your belief that they will get a higher price for their products, right?

Mr. PROFETA. Yes. This is the study that we released. I am happy to bring the authors who are intimately familiar with it to meet with you, Senator. But, yes, their findings were that the key benefit to the farmers comes from the indirect commodity market

shifts that drive up the crop prices and their revenues. They do have some benefits from the offsets, from tillage practices, manure management, et cetera, but that is not the driver. The driver is the crop price.

Senator JOHANNNS. Now, if you are on the buying end of that, though, if you are in the dairy industry—which is absolutely going broke at the moment, if you are in the pork industry and one pork producer said to me recently, he said, “Mike, we are 30 days from being bankrupt.” If you are in the cattle industry that has not made money for 2 years, this is pretty much a disaster for them, isn’t it?

Mr. PROFETA. I would like to go through the numbers with you. I do not think that the input cost projections that came out of the study are in the realm of disaster, particularly compared to the fluctuations we have had in those input costs in the past year. They far exceed what would be projected out of this legislation.

Senator JOHANNNS. Well, if you are the one going broke—and, believe me, dairy is not making any money at the moment, quite the opposite. Pork is really getting hammered. Beef has not been good for a couple of years. Call it what you want. This is not a good situation.

Mr. PROFETA. Senator, I would agree, and let me be clear. The intent of the study was try and get after, you know, the assumptions and lay them there and let you as a Senator to make a judgment as to—I am from the State of North Carolina. I work with the pork industry a lot. I know how they are suffering. And I am certainly not advocating for any legislation that would cause the kind of pain that you feel.

I think there are ways to balance these societal objectives, not hurting the industry and also addressing climate change, and what we are trying to do is give you the data that helps you get to that place.

Senator JOHANNNS. Now, let me, if I might, kind of pivot off of your comments to Mr. Glace. Mr. Glace, you are, as I have described, a big guy—not in stature. In business is what I am referring to. How big are you? What would your revenues be in a year?

Mr. GLACE. Approximately \$15 billion.

Senator JOHANNNS. \$15 billion. Now, if we do something up here that impacts your bottom line, you are just going to pass it on to the consumer, right? You are not going to go broke.

Mr. GLACE. Exelon believes that all costs to manufacture and inputs to make electricity ultimately get into the power price, and that does, in fact, get to the consumer.

Senator JOHANNNS. Yes. And if you are the irrigator and you are buying electricity, they are going to pay more, right?

Mr. GLACE. Yes, sir.

Senator JOHANNNS. One of the concerns I had with the study, the Texas A&M study, is the two farms they looked at in Nebraska were dryland, and about 60 percent of our row crops are actually irrigated. So those irrigators are going to pay more for electricity if, in fact, the Government raises the cost of doing business.

Mr. GLACE. We believe that power prices will increase, yes.

Senator JOHANNNS. Now, you can hedge your risk just simply because you are going to notify somebody in an electric bill that they

are paying more. But where the farmer does not set the price, how do they possibly compete with you? I mean, you are such a big enterprise. You can control your prices. The poor farmer out there just is going to get what they get, and if it causes them to go broke, they will go broke, won't they?

Mr. GLACE. Again, I cannot speak for the farmers' economics very specifically, but we do believe that all—Exelon believes in markets, and markets set prices. And whatever the buildup of the ultimate market inputs are that determine the market price, the market clears and the market sets a price. And Exelon believes that markets produce the least efficient—the most efficient, excuse me, possible outcome for the consumer, and that a market-based solution is always going to be the least cost or most effective solution.

Senator JOHANNIS. See, here is the problem with that in agriculture. The fat cattle guy cannot go to Tyson's and say, "Boy, you know, I just got a higher electric bill, and I got this and I got that. Instead of selling these fat cattle for \$100, I need \$110." Because you know what? Tyson's is going to go, "So what?" I mean, it is the reality of the marketplace for farmers. Do you agree with me there?

Mr. GLACE. I do not pretend to know the farmer realities and the farmer marketplaces, but I do know that if a market sets a price for clearing that the farmer will get a bill that is commensurate with that market price.

Senator JOHANNIS. They cannot pass it along.

Mr. GLACE. I will take your word for it.

Senator JOHANNIS. Yes. Well, that is the way it works.

Mr. GLACE. Absolutely.

Senator JOHANNIS. Thank you.

Mr. GLACE. Thank you, sir.

Chairman HARKIN. Thank you very much, Senator.

Now Senator Gillibrand.

Senator GILLIBRAND. Thank you, Mr. Chairman. I want to go over some of the issues that Ms. Winkler raised and some of the questions that you asked, Mr. Chairman.

One of the issues was about why do we need a customized market, and there were a couple of areas that I wanted you to perhaps provide—anyone on the panel who has information and wants to provide more detail, that would be helpful.

On the question of whether it will provide offset projects financed under the bill, will be able to provide the financing, one of the reasons is that financing for projects is often contingent on a firm being able to predict their future carbon risk through a derivative contract, for example, and if you just have exchange-traded, you have no more than 5-year-out contract.

So could you please elaborate more on that financing perspective, because the Chairman brought up, well, why can't you just get a loan? What is the difference with that access to capital, then the liquidity that the derivatives market would provide, if any, to further answer that question?

Ms. WINKLER. Thank you, Senator. One of the main differences is just because of the customized nature of that instrument and the financing needs for those particular projects that need to be developed. It is in their best interest to be able to deal with a

counterparty that is able to, you know, lend to them and also that they are able to contribute toward the financing of that the physical assets that they have. And in the cases of many of these project developers, these projects take anywhere from 7 to 10 years and, especially in terms of the offset projects, need to be verified and approved along the way. So there is a substantial amount of risk that is outstanding. A typical lender is going to find that pretty difficult to be able to stand behind that at a reasonable rate.

Senator GILLIBRAND. So you are saying that the lending market may not be readily available because of the outstanding risk, and so that you really need a derivative to hedge that risk specifically for the amount of time that that project may well take to come to fruition.

Ms. WINKLER. That is correct.

Senator GILLIBRAND. Now, is that your experience, Mr. Glace?

Mr. GLACE. Yes.

Senator GILLIBRAND. OK. Second, you said in your testimony, Ms. Winkler, that if you were going to have—if you were not going to have a customized market, it would leave out certain players who need access to these markets because of the capital requirements. But one of the things we talked about earlier that the Ranking Member brought up was that we would actually want capital requirements. And, in fact, not only do we want complete transparency for what the trade is going to be, but that we actually might even have higher capital requirements because of the increased risk. So that does not address your—that would undermine your argument that certain players would, therefore, be excluded from the market.

Ms. WINKLER. I think the way to describe it is that an exchange-traded market, we believe, relies on broad market participation, and that is kind of central to being able to have the market determine what that carbon price is going to be.

There are many differences in terms of the over-the-counter market and the level of sophistication of the people that interact in that market, and typically they are eligible contract market participants. And so I think there are pretty significant differences just between who we would anticipate dealing in that customized market versus what we would expect in the exchange-traded market. And it is certainly our hope and our intention that both markets have to have increased transparency over what they have today.

Senator GILLIBRAND. And capital requirements. I want to get to your argument that you thought the reason why we needed to have an OTC market was because there would be no capital requirements. And what I think the Ranking Member was getting at is if we create this over-the-counter market and allow for it, it is going to need increased transparency and significant capital requirements, which would undermine your argument.

Ms. WINKLER. The capital requirements is certainly something that is under review by the administration as part of their larger over-the-counter and financial regulatory reform. So we would view that anything that would need to be done in carbon over-the-counter ets would be in line with those broader goals of the administration.

Senator GILLIBRAND. And then the third issue that addresses this is the question of foreign carbon allowances to be purchased and used for domestic appliance. It is allowed in the Waxman-Markey bill right now. However, the issue of mandated standardization and exchange trading is impacted because 75 percent of the European market right now is over the counter. So how do you see that impacting the harmonization efforts that we are trying to make and participation—if the EU, for example, has a 75-percent over-the-counter market and the U.S. has none, how will that affect us in terms of competitiveness or access to capital or liquidity or volatility or any of the issues that you brought up?

Ms. WINKLER. I think the biggest concern, Senator, is that if there is not an over-the-counter market that is allowed in the U.S., we believe that that activity is going to take place—

Senator GILLIBRAND. Go overseas.

Ms. WINKLER [continuing]. And it is going to go overseas to less transparent environments and areas where our regulators do not have as direct authority as they do here in the United States. While we certainly still see, you know, some transactions taking place in the over-the-counter market, we have been seeing a trend in the EU ETS toward clearing. And that has been a positive trend, and it kind of speaks to how over-the-counter markets develop over time, and they do become more standardized, they do become more liquid. And now kind of the predominant number of the instruments are being cleared, and we would view that being as much of the same development that we will see here in the U.S. But our primary concern is that if we do not allow over-the-counter transactions, people are going to need those customized tools, and they are going to lend themselves to less transparent environments that we do not have the authority to regulate properly.

Senator GILLIBRAND. Thank you.

Chairman HARKIN. Thanks, Senator Gillibrand.

Senator Lugar?

Senator LUGAR. Thank you, Mr. Chairman.

In our last comprehensive hearing on this subject, the testimony of Secretary Vilsack was that all farms would benefit from a cap-and-trade situation similar to the House bill. Senator Chambliss, in releasing the Texas A&M study, which has been cited several times in the hearing, indicated that 71 farms would not prosper, 27 would, and so that is quite a disparity. And the reasons were varied, but the farms that came out best were farms such as my farm in Indiana that produces corn and soybeans.

I take the privilege of these personal references because I want to ask you, Dr. Miller, about a situation on my farm or maybe at yours. We have about a third of our acreage in corn, a third in soybeans, and a third in trees. About 22 years ago, my son and I started planting black walnuts in rows, some other trees subsequently, and in due course, the Chicago Climate Exchange approached us and said, "Would you like to be a partner in this exchange?" They wanted some farm in Indiana at least to have that situation going, but they could measure only most recently planted trees because the idea was that if you have trees already on the farm, why, those were already there. The incentive was to plant more.

So, as a result, they measured some of our trees, and I have been accumulating credits. I go to the website of CCX and find that I have no several thousand tons of carbon sequestered in those trees on the farm.

My problem is that the price of that carbon per ton has been plunging. It was as high one time as \$7 a ton. It is now 25 cents a ton as you go to the website today.

Now, there is something wrong with the market there, as we are all busy patting about climate change, and yet the markets are not reflecting that much is going to happen there.

Now, CFTC, in a very bold move, has taken CCX apparently under its wing and at least is hoping that this may be established as a market of sorts.

I go through all this detail to say that it is not at all clear, even if you were on a farm in which you wanted to put pastureland into trees or, as the Texas A&M study points out, most of the gain for the corn farmers comes from the fact that fewer acres apparently are planted. Therefore, supply and demand raises the price of corn, and that has all kinds of implications in terms of the American food system, quite apart from the worldwide food system in which our whole emphasis is on more acreage and more production with the population of the world growing.

These are all contradictory problems but relevant, I think, to the ordinary farmer who might contemplate. How do you, in fact, stay alive? Do you plant trees? Is there going to be a similar market for no-till planting? We have had celebrations at the Farmers Union, people here in our Committee.

I ask all of this simply to raise a question that maybe you can help answer. How established is it that there is going to be any market for my trees or any trees I should plant? How about the trees that are already there if I promise not to harvest them? You say a contract period of 5 years or 10 years. Do I get credit for that? Or is that in the past? Give me some inclination, if you can, from this practical example.

Mr. MILLER. The market is in its infancy, and in its infancy it will have more variation and gyration than it will in a mature market. But regulations matter, and one of the challenges that the current Chicago market has is that part of its tradable compliance instruments were deemed basically worthless by the future regulations. Therefore, that piece of the market is trending toward zero.

The offsets are not trading at zero, but they have had to move to the over-the-counter market to find value. And so when we sell offsets such as from forestry or soils right now, we are trading at 4 times, 5 times, 6 times what that listed exchange price is that is trading allowances that 2454 did not recognize.

So it is the same problem Europe had when they did not allow banking forward of a market that was long offsets in the current term or long allowances in the current term. They went to zero, and that is what markets do when you have an excess supply of something that has no carry-forward.

Relative to the ability for farmers to participate, we are at, again, the infancy of what all these solutions can be from the agricultural and forestry sectors in our markets. The CCX, which has the only broad-based set of workable protocols, is an incomplete

set. There is a real role for USDA to help set and develop additional protocols. Nitrous oxide management is one that possibly almost all farmers could participate in. But we have no standard protocol for that yet. It is a more expensive protocol to probably do. It is more difficult. It has got some scientific challenges.

At CCX, we took the ones that had the best science around them at the time we did them and started with those, and we have added protocols.

In the Texas A&M study, their ranches did not have any offset income in the Texas A&M study, and I am quite familiar with that. Partly, when they did their panels, the CCX rangeland offset requires management of the stocking rates, and those particular ranches in those representative panels could not economically do what is required of the CCX offsets in order to get offset credits. We have ranches that are complying with that—us, Farmers Union, various different aggregators—but it is not something that every ranch is going to be able to do and remain economically viable. And I think that is one of the things we have to be aware of. While it might be technically feasible for the individual resources that are available, it may not be economically viable to do the things that are required in order to earn offsets.

Senator LUGAR. I ran over my time, Mr. Chairman. I would just underline the importance for our Committee, if we are to adopt a cap-and-trade situation, to go well beyond the House bill and to get into the weeds, so to speak, of this because, otherwise, this is going to be a fiction that somehow there are allowances here, or credits or even a market, without somebody going into the details Dr. Miller has just illustrated in brief. And I think this is critical, or we are going to leave farmers absolutely without defense in this situation, I think zapped all across the board.

Chairman HARKIN. Senator Lugar raises a good point. I thought about this at that previous panel that, you know, you have a stand of trees, we had a forest, a private forest. Now, because he is not adding anything additional, therefore, he gets no offsets. But if he cut down his trees and planted new ones, well, then he would be OK. This is that same old thing that we have been through so many years on this Committee on conservation and other things. If you tear out what you have got and plant something else, well, then you will get the benefits. But if you just keep your conserving practices or what you have done to your land, then you do not get anything, and that just does not make sense to people. It does not make sense to me either. So we have got to address that also on this.

Well, thank you all very much, and we will call our next panel. Thank you very much.

Our next panel, our producer group perspectives, we have Mr. Andy Beckstoffer, and he will be introduced by our colleague. Come over here, Mike. Then Mr. Frank Rehmann, Chairman of USA Rice Producers' Group from California; Mr. Luke Brubaker from Brubaker Farms in—I had a wrong address here on it—Pennsylvania. Mount Joy, Pennsylvania. Mr. Fred Yoder, Past President of the National Corn Growers Association from Ohio. We will ask you all to take your seats there.

We are graced with the presence of a long-time friend of mine, our colleague from the House side, Representative Mike Thompson, and I am going to turn to him for the purpose of introduction because I know he has to get back to the House. But in my way of introducing the introducer, I will just say that Congressman Thompson was first elected to represent California's 1st District in 1998. It includes all of Napa, Lake, Mendocino, Humboldt, and Del Norte counties. I do not know what else you have added. Sonoma County, too?

Mr. THOMPSON. Part of Sonoma.

Chairman HARKIN. Part of Sonoma County, and Yolo, also. Prior to serving in Congress, Representative Thompson represented California's 2nd District in the California State Senate, where he chaired the Budget Committee. So, again, not a stranger to us at all, and a great friend and colleague from the House side. I will turn to Congressman Mike Thompson for purposes of introduction.

**STATEMENT OF HON. MIKE THOMPSON, U.S.
REPRESENTATIVE FROM THE STATE OF CALIFORNIA**

Mr. THOMPSON. Well, Mr. Chairman, thank you very much, Mr. Vice Chairman, thank you also for allowing me to do this. I have got a couple friends testifying today, but I have been asked and am honored to introduce one that I represent at home, and that is my good friend Andy Beckstoffer.

Andy is the founder and the Chairman and the owner of Beckstoffer Vineyards, which farms over 3,000 acres of vineyard in Napa, Mendocino, and Lake counties of California. He is the largest non-winery grape grower in Napa Valley and along California's north coast. He is also the largest seller of premium winegrapes in Napa and on the north coast area, and he provides grapes to over 80 premium wineries.

Since 1970, Beckstoffer Vineyards has been a leader in developing and implementing new vineyard technologies in the California premium north coast area, and Andy has been recognized around the world for these efforts. And I hope he gets a chance to talk about this, but he is doing some great stuff now, a whole bunch of new organic plantings in Mendocino County and Lake County, and something that he might not think is exciting, and maybe you will not either, but being a vineyard owner myself, we have to rip our land before we plant vineyards, and Andy now in his new plantings, he is only ripping the area specific as to where the grapes will be planted, not disturbing the rest of the ground, which I think is pretty cutting edge.

In 1975, he was a founding director of the Napa Valley Grape Growers Association. In 1976, he became a member of the Napa County Planting Commission and in 1983 a director of the Winegrape Growers of California. He is also a member of the World Presidents Organization, a director of the Wine Market Council, the California Association of Winegrape Growers, and the Land Trust of Napa County. And he is an accomplished conservationist. As a farmer and businessman, he understands that investing in the conservation of our land is an investment in our future. His leadership in helping build national support for increased tax in-

centives to put property into conservation easements will be felt for generations to come.

I carried that bill in the House. It has tremendous support over here in the Senate, and he was really the catalyst for that, helped put it together, and he not only talks the talk, but he walks the walk. After that bill was passed, he was the first landowner across the country to put his land into a conservation easement, and it is really significant because it is a historic vineyard in the Napa Valley. And if I told you the property values of a vineyard like that, most people in agriculture would not believe that they would draw that kind of money.

So he has been on the cutting edge. He has worked to restore the Napa River throughout the Napa Valley, and he is a lifetime expert in specialty crop farming. And as everybody in this room knows, specialty crops represent about 50 percent of the entire plant crop economy, and they contribute mightily to our Nation's nutrition.

He has a hands-on knowledge of how not only climate change is affecting winegrapes, but also the benefits that specialty crops provide in helping our country meet the challenges of climate change.

I want to thank you all for allowing me to do this, and I want to thank you in advance for listening to his comments. And I am just proud to be the one to have brought Andy to the Senate.

Thank you.

Chairman HARKIN. Thank you very much, Mike. You are welcome to stay if you would like. I know you have probably got—

Mr. THOMPSON. We are working on this thing called "health care reform" over there.

[Laughter.]

Chairman HARKIN. I have heard of it. I have heard of it. All right. Well, thank you very much, Mike.

Mr. THOMPSON. Thank you.

Chairman HARKIN. I really appreciate it very, very much.

Then we will start with you, Mr. Beckstoffer, and we will work from right to left in this regard. Mike was mentioning something about ripping grapes and stuff. I turned to Saxby, I said, "Is that like minimum tillage that we know about?" It sounds a little bit like that.

Also, I want you to know something else. In 2000, in my State of Iowa, we had a total of 100 acres of grapes in Iowa. We now have over 1,000. So look out, here we come.

[Laughter.]

Senator CHAMBLISS. Mr. Chairman, let me just say, too, that Mike happens to be the Chairman of the Wine Caucus over on the House side, and as a former Member of the House and a consumer, Mr. Beckstoffer, we appreciate you sending a little bit up here every now and then of your fermented product that we can make sure we test every now and then.

Chairman HARKIN. Mr. Beckstoffer, welcome, and please proceed. Again, I am going to ask you to summarize. As you probably have heard, all your statements will be made part of the record in their entirety. If you could sum it up in 6 minutes, please.

**STATEMENT OF W. ANDY BECKSTOFFER, CHAIRMAN AND
CHIEF EXECUTIVE OFFICER, BECKSTOFFER VINEYARDS,
RUTHERFORD, CALIFORNIA**

Mr. BECKSTOFFER. Thank you very much. I live in St. Helena, which is a small agricultural town in the Napa Valley of California, and my family grows winegrapes, as you said, and that in your terms is a specialty crop.

We are small farmers, but grapes are a big business. There are over 24,000 grape growers in the Nation, and the full economic impact of wine and grape products is estimated at over \$162 billion. Grapes are grown in over 40 States today, and grapes are a significant part of the specialty crop segment of the U.S. agricultural economy. Specialty crops, as Mike says, represent approximately 50 percent of the farm gate value of total plant agricultural production.

We in the winegrape and wine business are very proud of the fact that most medical people believe that wine is good for your heart. I truly believe and hope that that is true.

Chairman HARKIN. I believe.

Mr. BECKSTOFFER. But, for sure, grapes and peaches and pears and carrots and lettuce and tomatoes and all fruits and vegetables are specialty crops that provide essential nutrition to the American people. That is where their real importance is.

Where I live in the Napa Valley, it is a very well known premium winegrape-growing region. What is not so well known is that while some 9 percent of Napa County's land mass is devoted to vineyards, over 10 percent of the county's land is protected by some sort of open space or agricultural conservation arrangement. Conservation and environmental sensitivity are hallmarks of our lives in the wine country. The increased tax incentives on conservation easements which were legislated in 2006 have made a major contribution to our ability to conserve these agricultural lands. In our small valley, over 1,650 acres have been put under conservation easements since 1960, and over 300 of that has been our lands.

Senator Baucus here in the Senate and Congressman Thompson in the House are now sponsoring legislation to make those incentives permanent. These incentives are crucial to land conservation. They are crucial to keeping small farmers on the farm and ultimately crucial for positive climate change.

In considering my testimony, in the limited time I want to emphasize three major concerns.

First, specialty crop growers are generally relatively small farmers. Our family is the largest vineyard owner in the Napa Valley and the north coast. But on any statistic involving all farms, we are very small farmers. This is the case with most specialty crop farmers. We are scattered politically and geographically and do not have the organization or capacity to compete with the large program crops for adequate consideration in major legislation, such as that involving climate change. Without your special indulgence and careful consideration, much of the Nation's nutrition engine will suffer.

Second, it has been widely reported that many car dealers have opted out of the Cash for Clunkers program because of the heavy documentation requirement on their limited staffs. We have simi-

larly limited staffs. I would hope that the reporting requirements of any climate change program would be held to the minimum.

Third, the USDA's Economic Research Service reports that between the years 1997 and 2002 over 8 million acres of American farmland have been lost to agriculture due in good part to urbanization and economic pressures. In California, our population is estimated to double in the next 25 years.

In the Napa Valley, some 60 miles from San Francisco, there is tremendous urban pressure. It is my view that winegrape vineyards here are the long-term highest and best economic use of the land. And for this reason, we have been able to preserve the vineyards with that urban pressure. This is true in varying degrees in all agricultural lands near urban areas. These lands in many cases are relatively small specialty crop lands. It is widely anticipated that Federal and State carbon reduction programs will increase costs for energy, fertilizer, pest management tools, and other inputs such as transportation. If winegrape growers and agriculture are not excluded from any carbon emissions cap while being able to receive credits for offsets provided, these unaddressed increased costs will result in the loss of an additional increment of agricultural lands.

Further, it is my understanding that agriculture, through plant and soil sequestration, has been identified as a priority area for cap-and-trade offsets. If the profitability of agriculture is further reduced through increased costs and competition from foreign wines made with cheap labor with Government supports, that will serve to limit the availability and expansion of agriculture as an important component of any cap-and-trade program.

The winegrape quality and standards in the Napa Valley are in no immediate danger or short-term danger from climate control activity. There are some things that are changing, however. For example, we are experiencing more heat spikes. Generally speaking, heat and sunlight bring beneficial effects to grape ripening and maturity. We prepare our trellises and canopy management to accept and accentuate this. When heat spikes occur, they damage the grapes and thus we must prepare our trellises to avoid sunlight and heat—in direct contradiction to our major objective of heat and sunlight accumulation.

The nights are getting warmer. The secret of producing great winegrapes involves achieving a chemical balance between sugar, acid, and pH. Sugar is accumulated during the day, acid in the cool nighttime temperatures, and pH at both times. Climate change is increasing our nighttime temperatures, and at this time we have no way of knowing the effect on grape balance and quality. We greatly need research to show these effects. I understand that most of the carbon sequestration research has been done on annual crops. Our vines with a 20- to 40-year life span have a significantly different carbon footprint, and their relationship to annual crops should be analyzed.

Another area where climate change is beginning to affect us is pest infestation. The disruption in the ecosystem is producing new pests and mutations and vine diseases that we just do not understand. This could have a major effect on our ability to limit pesticides.

For reasons of economics, fruit quality, and soil and water conservation, we have over the past many years drastically reduced our tractor usage in the vineyards. We limit irrigation practices for reasons of fruit quality, and when we do irrigate, we use effective drip irrigation. We make extensive use of cover crops to host beneficial insects and limit pesticides as well as reduce tillage to limit soil moisture. We—

Chairman HARKIN. Mr. Beckstoffer, could you summarize?

Mr. BECKSTOFFER. OK. We in the grape business have been practicing for a long time, and we just hope that these early practices will be recognized in any potential carbon market or offset program.

Thank you very much.

[The prepared statement of Mr. Beckstoffer can be found on page 65 in the appendix.]

Chairman HARKIN. Thank you very much, Mr. Beckstoffer. I am sorry. We are just running out of time.

Next, Mr. Frank Rehermann, Chairman of USA Rice Producers' Group, also from California. Welcome, Mr. Rehermann. Please proceed.

STATEMENT OF FRANK REHERMANN, CHAIRMAN, USA RICE PRODUCERS' GROUP, LIVE OAK, CALIFORNIA

Mr. REHERMANN. Good afternoon, Chairman Harkin, Ranking Member Chambliss, and members of the Committee. My name is Frank Rehermann, and I am a rice producer from Live Oak, California. Since 1972, my wife and I have produced rice in a family partnership which now includes our two sons. I currently serve as Chair of the USA Rice Producers' Group, one of four organizations which comprise the USA Rice Federation. And, incidentally, Chairman Harkin, I am proud to say that all 850 acres I farm are enrolled in the CSP program.

Chairman HARKIN. Good for you. Thank you.

Mr. REHERMANN. The USA Rice Federation is the global advocate for all segments of the rice industry. Our multi-billion-dollar industry provides jobs and income for a broad and diverse array of people in the value chain. Beyond our obvious economic and nutritional benefits is the fact that we provide winter-flooded habitat for important species of migratory waterfowl and other species. That habitat is critical to their very survival.

Our objections with climate change legislation as recently passed by the House lie in the area of increased production costs. Hopefully, our own Congress will not approve legislation that will have, may have the unfortunate, albeit unintended, consequence of shifting rice production to our foreign competitors because we can no longer compete.

The U.S. rice industry is already faced with the importation of some 750,000 tons of rice per year from foreign origins, and, therefore, competing in our own markets has become more difficult. And as that happens, the natural consequence of that would have an effect on the Nation's ability to provide food security. That would be placed at further disadvantage.

We currently have few, if any, opportunities in rice production to further sequester or reduce greenhouse gases. However, on a

proactive basis, work is newly underway in California to develop computer modeling techniques to quantify greenhouse gas emissions and, accordingly, to estimate emission responses to possible changes in cultural practices. All factors will be evaluated to determine their feasibility.

However, as of now, we cannot identify a way to offset the increases in production costs of rice attributed to H.R. 2454. Moreover, the much discussed study by Texas A&M demonstrates that on all rice farms sampled, production costs will go up significantly, and that causes our bottom line to reduce significantly and ultimately has an effect on equity.

The American Farm Bureau Federation estimates that just the increase in rice production cost per acre could reach as high as \$153 per acre. Within that margin lies any ability we have to show a profit.

Additionally, we consider it highly unlikely that rice-producing countries with whom we compete will impose onerous regulatory burdens, as evidenced by historical evaluation. Therefore, we respectfully urge the members of this Committee to fully evaluate alternative approaches to curbing greenhouse gas emissions and to oppose pending or similar climate change legislation.

We have some suggestions that we would like to make today, but in the event that legislation similar to H.R. 2454 is considered in this body, we believe there are several key provisions which must be clearly and explicitly included in the bill to help ensure U.S. agriculture is not irreparably injured in the process.

One, a specific exemption should be included for the agriculture sector from the greenhouse gas emission reduction requirements of climate change legislation and the underlying Clean Air Act.

Second, a definition of "agriculture sector" for the purposes of this exemption should be clarified to include production as the path from the field through the stage of processing necessary for the commodity to be marketed in commercial channels.

We will need additional funding to accomplish more research by USDA and the land grant university system. We need the establishment of a program using the funds and authorities of CCC to compensate producers for their increased input costs. We would like to see the establishment of a robust agricultural offset program that is flexible and run entirely by the USDA.

In conclusion, I urge this Committee to work and the Senate to postpone consideration of climate change legislation until such time that alternative legislative approaches for curbing greenhouse gas emissions are developed which do not injure American agriculture. If this effort, however, is unsuccessful, we request that this Committee work with other committees of jurisdiction and your Senate colleagues to ensure that our recommendations are included in any climate change legislation enacted into law. We believe that these provisions in the current approach to climate change would be very detrimental to the U.S. rice industry.

Again, thank you for the opportunity to present our views. I will be glad to answer any questions.

[The prepared statement of Mr. Rehermann can be found on page 116 in the appendix.]

Chairman HARKIN. Well, thank you, Mr. Rehermann, for being here and thank you for your testimony.

Now we turn to Mr. Luke Brubaker of Brubaker Farms of—*is it Mount Joy, Pennsylvania?*

Mr. BRUBAKER. Mount Joy, right.

Chairman HARKIN. Mount Joy, Pennsylvania. Welcome, Mr. Brubaker. Please proceed. I am sorry. I was looking at your folder here.

STATEMENT OF LUKE BRUBAKER, BRUBAKER FARMS, MOUNT JOY, PENNSYLVANIA

Mr. BRUBAKER. Thank you, Chairman Harkin and Ranking Member. And I am so disappointed my Pennsylvania Senator just left me earlier, and all the rest of the members, I was going to address them, but they have gone.

Chairman HARKIN. That is all right.

Mr. BRUBAKER. I would like to thank you for the opportunity to speak before you today about the issue of global warming. I do not come here today as an expert on global warming, but to tell you some of the great things that happen on Brubaker Farms, and I believe that we can have an impact on the atmosphere and on global warming.

To begin, I would like to speak with you about Brubaker Farms Dairy and dairies in general and how they can profit from the product—manure—which, in some cases, is thought of as a liability rather than an asset.

I like to think of myself not just as an environmentalist, but also as a business leader where I can lead in the local community and represent dairy farmers on State and national issues. Please refer to my short bio which I believe you received.

Brubaker Farms of Mount Joy, Pennsylvania, is owned by my wife and myself, in partnership with our two sons, Mike and Tony Brubaker. My father purchased the farm in 1929 and started the operation with eight cows. My brother and I purchased the farm in the early 1960's, and at that time it was an animal operation that consisted of 18 cows. In the early 1990's, my sons graduated from college and wanted to come back to the farm to be a part of that operation. At that time, my brother sold his interest in the farm to me and my sons, and we entered in to a formal partnership to manage Brubaker Farms. At the time the partnership was formed, the Brubaker animal operation consisted of 200 cows. The farm now consists of over 800 cows, 600 young stock, and also a 250,000 bird broiler chicken operation per year. These expansions to the operation allow it to provide the necessary income to sustain the three families that now rely on it for their economic well-being.

We have developed an operation that is both financially stable and is an important part of the local economy. We have taken actions to ensure that the site is maintained as a working farm in the future through participation in the Pennsylvania Farmland Preservation Program. In order to address farm commodity price issues, farm expenses, and family financial needs, we are ready to make the necessary business decisions to ensure that the farm will continue to be viable into the future. The farm is a family business, and the economic viability of the operation is critical in order to

allow it to continue to be an effective business well into the future, and for it to be an economically sustainable family enterprise.

The most recent project we have completed is a manure digester. We are excited about what this new addition means to our farm and to the energy security of Lancaster County, Pennsylvania, and neighboring communities. At the present time, our digester is generating approximately 4 to 5 megawatts of electricity a day. Most of the electricity that we generate is sold back to the local electric utility company, PP&L. We have the capacity of producing enough electricity to supply approximately 150 to 200 homes a day, and most of that is closer to 200 homes a day now.

Key to the methane production is the cows and heifers. The manure flows by push and gravity to a recovery pit where it is pumped into a large lagoon of approximately 700,000 gallons and where bacteria in the lagoon converts volatile solids in the manure into biogas or methane gas. The lagoon is completely covered and insulated. The gas flows underground into the generation building which houses a large Guascor engine and generator capable of producing 225 kilowatts.

Now I would like to speak to some of the advantages of a methane digester: reduces the strain on the PP&L grid; reduces the need for electricity produced from fossil fuel power plants; reduces pathogens in the digested manure; separates the solids from liquid and recycles the solids for bedding; reduces the odor by 75 to 90 percent after digested; fly larvae are killed by the digester, resulting in less flies; reduces methane and other greenhouse gases into the atmosphere; weed seeds killed in digested manure which in turn can reduce chemical use; selling electricity to the local power company as renewable energy.

We are permitted to add food by-products that can be metered to the manure which makes extra electricity; possibility of partnering with cafeterias to use food scraps added to manure rather than land filling which also makes electricity. In turn, this can result in a profit to the farmer.

Methane is one of the potent greenhouse gases. It is 20 to 23 times more powerful in trapping heat in the atmosphere than carbon dioxide. We make a profit from the sale of carbon credits to industry or individuals who need or want to offset emissions.

As a greenhouse gas, methane differs from carbon dioxide in an important way. Methane remains a climate change threat in the atmosphere for a number of years.

The reduction in the methane from our digester can lead to a slowing of climate change. Use of the manure after it goes through the digester is readily available to plants for plant food, which in turn helps prevent leaching and a chance for run-off.

As you know, in this critical time, the dairy farmer has some financial difficulty. Some of the things we talked about today could help the dairy producer. And as a side note, I would be happy to offer suggestions or ideas that could help correct the dairy situation.

I believe that over the next 10 years, environmental and renewable energy issues are going to be some of the biggest challenges for agriculture and farmers. Using State and Federal funding and loan assistance for this project and our new solar project to produce

electricity for about 150 homes on the roof of our new heifer barn helps Brubaker Farms make our goals a reality.

I believe investing in projects like these is good for the future of the dairy farmer industry and livestock industry, the economy, the environment, and the whole world.

I will be glad to answer any questions that you might have, and thank you again for the opportunity to speak today.

[The prepared statement of Mr. Brubaker can be found on page 71 in the appendix.]

Chairman HARKIN. Well, Mr. Brubaker, thank you very much. Very stimulating. Very stimulating.

Now we turn to Mr. Fred Yoder, Past President of the National Corn Growers Association, from Plain City, Ohio. Welcome, Mr. Yoder. Please proceed.

STATEMENT OF FRED YODER, PAST PRESIDENT, NATIONAL CORN GROWERS ASSOCIATION, PLAIN CITY, OHIO

Mr. YODER. Chairman Harkin, Ranking Member Chambliss, it is a pleasure to be here. Unfortunately, somebody has to be last, and I guess today I was the last one. I guess I am just lucky.

Again, my name is Fred Yoder. I grow corn, soybeans and wheat near Plain City, Ohio, and I have been an active participant in climate change discussions for many years. In December, I had the opportunity to attend and participate in the United Nations World Climate Conference in Poland where I was able to discuss the role of agriculture in reducing greenhouse gas emissions. Also, in addition to being part of NCGA's efforts, I serve on the boards of numerous ad hoc groups, including the 25x25 Carbon Working Group and the Ag Carbon Market Working Group here in D.C.

I feel strongly that agriculture needs to be considered a significant part of the broader solution as we evaluate ways to reduce greenhouse gas emissions. Our Nation's farmers can play a major role in the market-based cap-and-trade system through sequestering carbon on agricultural lands. In fact, numerous economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap-and-trade program for consumers.

In the near term, greenhouse gas reductions from livestock and agricultural conservation practices are the easiest and most readily available means of achieving reductions on a meaningful scale. The EPA estimates that ag and forestry lands alone can sequester at least 20 percent of all annual greenhouse gas emissions in the United States.

Further, agricultural producers have the potential to benefit from a properly crafted cap-and-trade system. Given these opportunities, it is critical that any climate change legislation seeks to maximize agriculture's participation and ensure greenhouse gas reductions while also sustaining a strong farm economy.

For years, corn growers have adopted conservation practices such as no-till or reduced tillage which result in a net benefit of carbon stored in the soil. In fact, on my farm, I engage in both no-till and reduced tillage. Also, for the past 5 years, I have worked with my State association, the Ohio Corn Growers, on a research project with Dr. Rattan Lal of the Ohio State University on soil carbon sequestration research. As part of our research, we have on-farm

plots at six different locations to study various soils and their carbon capture capabilities. I have been actively engaged from the beginning in defining the research protocols, and this is just one example of the proactive steps our industry has taken.

NCGA was pleased with the inclusion of a number of agricultural offset provisions during the House negotiations on H.R. 2454. However, we currently have a neutral position on the legislation until we finish conducting an economic analysis of the House bill. We expect to have preliminary results of our study coming in the next few weeks, which will better explain the potential cost increases and income opportunities for corn production under the American Clean Energy and Security Act. We must get this nailed down.

Perhaps one of the largest unresolved issues in H.R. 2454 is the treatment of early actors and the definition of "additionality." Producers who have taken steps to sequester carbon or other greenhouse gases should not be at a competitive disadvantage by being excluded from selling credits for future offsets that occur as a result of ongoing efforts. The House bill acknowledges this by allowing the generation of new carbon credits for producers who initiated sequestration practices as early as 2001; however, NCGA does not believe that this language is inclusive enough.

Planting and tillage decisions are made each and every year, and there is no guarantee that a producer will decide to continue the same practice as the previous season. Each and every crop we grow sequesters additional carbon, and Congress should not establish policies that offer perverse incentives to producers to discontinue their conservation practices.

To that end, NCGA supports the development of an "avoided abandonment" offset credit so that no-till producers can participate in a carbon market for their ongoing sequestration activities regardless of when that practice began.

As an aside, the House-passed version of H.R. 2454 also includes an important provision related to the Renewable Fuels Standards. The House bill prohibits EPA from considering indirect land use change when conducting their life cycle analysis for corn-based ethanol until a peer-reviewed study can be conducted to verify the scientific accuracy of the model.

NCGA disputes recent data that would suggest direct correlation between domestic ethanol production and international deforestation. The language in the House bill is a step in the right direction toward sound science and a more rational life cycle analysis. We would urge that the Senate include the same provision in its version of the climate bill.

In conclusion, it is our hope that we can continue to work with the Senate Agriculture Committee to ensure Congress chooses the best path for agriculture and rural America. I thank the Committee for its time, and I do look forward to your questions. Thank you.

[The prepared statement of Mr. Yoder can be found on page 132 in the appendix.]

Chairman HARKIN. Well, thank you very much, Mr. Yoder. Thank you all.

I will just start with you, Mr. Yoder, on what you just kind of closed on. The whole idea of stackability is one that we have looked at, and we will be making, obviously, strong recommendations on

that so that a farmer might be able to get CSP-type payments and do other things and still get to be able to get offsets for carbon sequestration. That is a little bit easier than the early actors.

Now, the early actors, as you point out, was under 2001, I think it is in the House bill.

Mr. YODER. That is what was in the House bill.

Chairman HARKIN. But what about the case of the forester we had here in an earlier panel we had in July, where he is the third generation—I forget. They had 1,000 acres of timber or something like that, but they do other kinds of farming, too. Obviously, it has been in their family a long time. Obviously, they are sequestering carbon. If he cuts down all those trees and plants new ones, he gets to sell offsets. If he does not, he gets nothing. So I think that whole thing has to be addressed because that is a pretty permanent practice to have timber like Senator Lugar has on his farm. So both of those, you raise those issues, and they are very important issues to us.

Mr. Brubaker, very stimulating, what you are doing there. I guess the question I would have is: How have your neighbors in Lancaster County who also raise livestock, how have they reacted to the addition of a methane digester to your operation? There are other dairy farmers around you.

Mr. BRUBAKER. Right. There are many dairy farmers. If Lancaster County was a State, we would be, I think, about number 11, maybe number 12 now. If just Lancaster County was a State, for the number of dairy cows, we would be about number 11 in the United States. So, yes, there are a lot of dairy farmers around, and we are getting a lot of interest in building methane digesters. They are coming from Vermont. They are coming from Minnesota. They are coming to look at our digester. And we are not the only digester in the United States. Do not misunderstand me. I think there are about 110 digesters, give or take, in the United States. But we just built this probably about 2 years ago—well, about a year and a half ago we built it. We started thinking of this in about 2006. I guess that was when milk prices were a little weak then, and we thought, “We have got to find another profit.” And we decided it would be a profit coming from the back end of the cow, and so we decided to build a methane digester, which we are getting so much interest in. Our power company in Pennsylvania is paying us a good price for electricity, and that is what I hear around the country, that power companies are not paying a good price for electricity. They are paying us a good price for electricity, and we are selling carbon credits, and it is a win-win situation.

So that answers some of your question.

Chairman HARKIN. I assume you are just running the methane through, what, kind of an engine or something that is turning, a generator? Is that the way you are doing it?

Mr. BRUBAKER. Yes. If you look on the back side of the paper that I—that is actually the picture of the digester right there. And from that digester there, you will see over there at the far left, there is some piping that runs about a 6-inch pipe over into an engine room, which runs a big, almost a 400-horsepower Guascor engine, which runs a generator, which we are selling the electricity right onto the grid.

Chairman HARKIN. Is this economically viable to do something like this? Can you actually make money on something like this?

Mr. BRUBAKER. Well, yes, we are making money on it, and that is why people are looking at it. We did have—in about 2006, Governor Rendell was out to the farm for a meeting, myself and my two sons and the two Secretaries of Agriculture. We took a little trip after the talk, and we sat him beside the manure pit, and we told him what we want to do. He did some writing and said he wants to look into this situation. It was not too long until Pennsylvania had a Harvest grant. We got a Harvest grant, and we also got a grant from USDA which made it work for us to take the risk to build a digester, which it cost about a million and a quarter to do. But if everything goes well, the way we are producing, we are way above expectations on producing electricity, and we should pay it off in 3 to 4 years. And if we would not have had the grants, I believe we could have paid it off—could pay it off in, to be conservative, 8 to 10 years.

Chairman HARKIN. Mr. Rehermann, again, one of the benefits of having you here is, again, to highlight the fact that different parts of agriculture do not fare as well under the proposed legislation, and one of those that has come to our attention are the rice farmers.

I have heard mention of methods to reduce methane emissions from rice farming. I guess that comes from the straw or something? I do not understand that. But are there any kind of practices like that that would be viable as an offset practice for rice farmers?

Mr. REHERMANN. For approximately, Mr. Chairman, the last 30 years, we have investigated methods by which we can rid ourselves of our straw, which yields about 3 ton per acre, a good rice crop. We have sought alternative uses, and to date, we have no feasible, large-scale alternative use for rice straw. And so most of it is incorporated into the soil. Certainly that leads to methane gas production.

We continue that plight. We continue to search, but we have no real evidence that we are going to be able to sequester or reduce the emissions any more than we do.

We irrigate. We are under constant irrigation. We use a fairly high amount of nitrogen. We till the soil. Our soils are heavy clay and not well drained. All those things lead to the emission.

Chairman HARKIN. Again, it is a balancing here that we are trying to do here. There have been, obviously, a lot—well, I have gone over my time. I am sorry. I was not paying attention to the clock. I will finish there, and if I have a follow-up, I will follow up later.

Senator Chambliss?

Senator CHAMBLISS. Well, gentlemen, thanks for your testimony here today. Mr. Yoder, always good to see you.

We have talked about the study that Texas A&M did that has just been released in which there is a very distinct difference in farmers who would prosper from this versus farmers who would struggle from it. We heard some of that from you folks here.

We have got to develop a policy that hopefully will benefit all farmers and ranchers across America and not just a policy that is going to—in this case, as the Texas A&M study showed, would particularly benefit Midwest farmers and corn and soybean farmers.

Do you have any advance understanding of what your study is going to show with respect to this particular piece of legislation and its effect on corn that may be grown in Georgia or North Carolina versus corn that may be grown in the Midwest?

Mr. YODER. Well, I cannot really say for sure what the study that we are doing right now will say, but I will say this: With our work in Ohio with Dr. Lal from Ohio State, there is a definite difference in soil's ability to sequester carbon. So there will be some differences across the country. It is not going to be one size fits all. In fact, if Senator Johanns was here, in the sandy soils of Nebraska it would be virtually impossible to generate a credit from soil sequestration because of the sandy soil, the lack of organic matter.

However, the study that you are referring to from Texas A&M really only looked at two types of offsets, and that was no-till sequestration and also methane digesters. And so it was really kind of narrow in scope.

The other thing, too, that we have to consider is that in the Waxman-Markey bill there were 13 different projects that they listed as projects for agriculture to participate, and it is much broader than just no-till sequestration or methane digesters. For instance, raising a cover crop or reducing the amount of water that you irrigate with, with maybe some varieties that take less water, reducing nitrogen use and things like that.

So I think the thing we have to do in order to make this work for all of agriculture is to come up with scientifically based verifiable projects that we can do clear across the United States and not put one part, like Georgia, at a disadvantage compared to an Iowa or something like that. I think we have the science to do this, but I think it is important for your Committee to really work on broadening this and making sure that we have some science-based projects that everyone can participate in and not just a few.

Senator CHAMBLISS. All of the testimony thus far that we have heard indicates very strongly that we are going to see a rise in input costs. Apparently, nobody is in disagreement with that, whether it is nitrogen or petroleum or whatever it may be. So in order to continue to generate a profit from a corn-growing standpoint, obviously you are going to have to get a higher price for it, which we all assume that would be a likely scenario. Otherwise, as the Texas A&M study showed, the only way you are going to see corn and soybeans prosper is for acreage to come out of production, which means farmers going out of business.

Mr. Brubaker, if that scenario does play out and we see a significant increase in corn prices—we have heard testimony that we are going to have an increase in electric prices, we are going to have an increase in the other feedstuffs that you use in your production. With the dairy market in very tough times right now, what is that going to do to your operation?

Mr. BRUBAKER. Well, maybe we are in a better position than some, but I want to try to look at it as the whole picture of dairy and livestock producers. Maybe one thing you could do would be if a farmer participates in the carbon sequence in one way or another, that you would offset his expenses, his fuel expenses or something like that, if that is going to raise fuel and electric costs.

I am just trying to think of something that would offset it. Exempt that farmer if he participates in the program, offset his fuel prices, electric prices, or doing something like that. Maybe that is an opportunity, or maybe that is an encouragement.

Senator CHAMBLISS. Well, we are in an atmosphere, unfortunately, that rather than increasing subsidies, we keep getting shot at from the standpoint of decreasing subsidies. And it makes it pretty difficult.

Frank, good to see you as always, too. Thanks for being here. The Texas A&M study as well as other studies have shown that rice farmers are not going to fare too well for the reasons that you enumerated. What is this going to do to you and the international market? If the United States forges ahead with a cap-and-trade program, where are rice growers in this country going to be from a global market standpoint?

Mr. REHERMANN. Senator Chambliss, we cannot help but be severely disadvantaged by that if we lose our ability to compete in that global marketplace, and we are constantly being reminded that in order to effectively compete, we have to be a lower-cost producer than trending higher. We have had the same impacts on our input costs, the energy-related input costs that every other business in the United States has had. The principal difference, as you know, is that we cannot pass those costs along to the consumer.

So I peril to think of the disadvantage we are going to be in the export market. We are having a more and more difficult time, as I mentioned, competing against imports into this country.

Senator CHAMBLISS. Well, and I know some of the difficulties you are experiencing now. The last couple of years have been pretty tough years in the rice industry from a global competition standpoint. And if we are looking at increasing your input costs without seeing a collateral increase in prices, are we going to see more and more rice growers go by the wayside?

Mr. REHERMANN. I fear that in this country you will. I think that the people who will benefit will be the growers in the countries that do not implement such onerous regulations, our competing nations—Vietnam, Thailand, Burma. If China and India export, we have big trouble there. I do not look for them to lead the way in climate change initiatives.

Senator CHAMBLISS. Mr. Beckstoffer, I am particularly interested in how a small California winegrape grower can provide offsets under this cap-and-trade program. Can you tell us what emission reduction or carbon sequestration activities winegrape growers are doing now and what they can do under an offset program? And I apologize. We just do not grow a lot of grapes over our way. A lot of muscadines, but not grapes, are used extensively in the manufacture of wines. So educate us a little bit about what you are doing and what can be done.

Mr. BECKSTOFFER. We do not plant grapes but once every 40 years, so that we do not do new things that often. So as many of the people on this panel have said, if our early practices where we sequester carbon every year based on what is already in the ground is not give credits, we are not going to get many credits, because we simply do not do that.

What we do for reasons of grape quality, if you will, and soil conservation is that we—we are very worried about compaction and things of that sort, so we do not drive tractors that much. We are worried about pesticides, so we grow cover crops so we can host beneficial insects and things of that sort. We use drip irrigation so we do not use a lot of energy to irrigate. But all of those are practices that we do every year, and so somehow or another, we must get credit for the photosynthesis and for the carbon sequestration we do with our normal business practices, and that for plants that are planted every 40 years, as Mike Thompson was saying, we do this precision ripping, and that cuts down on tractor usage. It cuts down on carbon because you are actively—you are turning the soil.

But we started that because the rocks were really big and it cost a lot of money to move those rocks. But most of the things we do for wine quality and for soil conservation are things that would help climate control, plant and carbon sequestration. But you have got to give us credit for what we do every year, or we are not going to get much benefit.

Senator CHAMBLISS. All right, Mr. Chairman, I think that is all I have right now. Thank you very much, gentlemen.

Chairman HARKIN. I have another one to ask Mr. Beckstoffer, and that is, it seems to me that you are in a unique position. Your vines are long-term type, carbon sequestration, 30, 40 years on some of these vines. Do I assume that you also—do you do any kind of cover crop in between your vines and stuff like that?

Mr. BECKSTOFFER. Yes, we do, and we do that—what we do is we do it to dry out the soil. We plant the kind of crops that would dry the soil in the spring and then would go away when the plant needs the soil in the rest of the summer, because in California we get rain from November to March and not any time in between that. But our vineyards are—there is a cover crop between the rows that we mow and we do not turn the soil anymore. We mow it, and we mow it only, say, once a year because the kind of crops we do die in the summertime because we do not want to use the soil—we do not want them taking up our soil moisture.

But if you would look at a vineyard, you would see—we plant over 1,000, 1,200 vines per acre, so that is very intense in terms of the green foliage there, which is the photosynthesis. But the ground much of the year is green as well.

Chairman HARKIN. Well, thank you all very much. I just have to respond to my friend from Georgia here on this issue of the increased input costs and the increased price for feed for our dairy farmers or hog farmers or cattle farmers.

Senator Thune and I just had a hearing out in Sioux City here a week or so ago on energy, basically biofuels, and it was stated there by not only growers but some of the representatives of our big seed manufacturers that 300 bushels per acre of corn is not too far in the distance. In fact, I think it was—let me see. It was DuPont or the other one, Monsanto—I forget which one—which they predict that by 2020—they did not predict. They said it is certain that we will have a 40-percent increase in the productivity of corn per acre in this country. And that is not even taking into account some of the genetic research that is going on now, in corn especially. I am probably particular to corn because of Iowa, but corn

where they are developing strains of corn that use less water, that can grow in different parts of the world with less water. Some of it may even be brackish-type water that the plant can utilize like—I always point out there are some plants that produce fruit or something that use sea water, but they have a gene in there that says, “Salt, you stay here, and we will take the fresh water.” And they are finding that—like coconuts being, of course, the most obvious one. So if you can find those kinds of genes that we could help introduce, then we could grow corn in a lot of different areas that we are not growing it now.

So we are going to have—I am told it was Monsanto who said that we will have 300 bushels by 2030. Pioneer said we would have a 40-percent increase in 10 years, so that is basically equivalent from both of them. So there is a lot of—we are going to produce a lot more corn per acre in the future. And that is good. That is very good for all of us. So I do not think we have reached the limits of our research yet on those areas.

Well, thank you all very much; this has been very helpful to us, all your testimony. Rest assured we are trying to figure out how we can give the best information possible to the other committees when they bring this up—sometime, I do not know when, maybe this fall.

Thank you all very much, the Committee will stand adjourned.
[Whereupon, at 1:06 p.m., the Committee was adjourned.]

A P P E N D I X
SEPTMBER 9, 2009

(57)

SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
Global Warming Legislation: Agricultural Producer Perspectives and Trading Regulation Under a Cap and Trade System
Wednesday, September 9, 2009 — 10:00 a.m.
216 Hart Senate Office Building
Opening Statement—Senator Kirsten Gillibrand

Thank you Mr. Chairman and thank you for holding this important hearing.

Thank you also to the witnesses here today to help us understand the market we will be creating under this bill. Understanding how this legislation will impact, manufacturers, farmers, and energy producers who will depend on this market is critical for ensuring its success.

I would also like to particularly thank Chairman Gensler for his work and attention on this issue. He brings a wealth of experience to this issue and has been consistently generous with his time and energy in helping to analyze this new market.

I believe that reducing the emissions that cause global warming is a critical goal for environmental and national security reasons. But I also believe that a cap and trade system, setting our country clearly on a path away from fossil fuels, provides our country and the State of New York with strong economic opportunities. If we move swiftly to seize them, we can fuel our economy for decades to come.

Today, and over the weeks and months to come, I am going to continue to listen carefully to concerns from farmers and businesses and work to ensure that all New York industries thrive under a new cap and trade system.

In recent months, New York has suffered with the traumatic repercussions of last fall's financial crisis. As the global home of finance, New York has lost tens of thousands of jobs and billions in income as a result of financial collapse.

A cap and trade system and the well-regulated trading and financing of carbon and carbon offsets offer a much-needed growth opportunity for New York's financial sector.

According to some estimates, carbon is expected to rapidly become the world's largest commodities market if the United States enacts cap and trade legislation and, like other commodities users, companies using carbon permits will depend on the financial sector to provide liquidity in the market and manage risk.

The financial sector will also play a critical role in financing clean energy investments and fueling innovation. Firms looking to reduce their carbon footprint will depend on the financial sector to provide them the necessary capital. Farmers looking to sell carbon offsets will also depend on the financial sector to fund the new practices that can sequester carbon and reduce global warming.

Our success in combating climate change will in large part depend on our ability to fund carbon reduction projects. To be successful, we must create a quality regulatory regime for carbon that instills confidence in potential investors around the globe and protects American farmers and consumers.

We need to empower regulators to take action to control excessive speculation and market manipulation to prevent unnecessary spikes in the price of carbon permits. We must require transparency in the marketplace and provide regulators the tools to take action to ensure a smooth-functioning market.

At the same time we need to create a regulatory regime with sufficient flexibility to allow businesses to develop new technologies and make long term investments.

Firms looking to make these types of investments need to be able to manage their carbon risk over the long-term in a way that standardized products may not allow. Similarly, the offset projects that we must encourage our nations farmers to embark on may require highly customized financial products.

To achieve both these goals we must also bring real regulation to the market for customized products. This will mean creating new transparency requirements, so regulators and the public can monitor risks being taken, and pricing such transactions to reflect their higher risk.

We should also work to integrate our efforts into broader reforms of the derivatives market, to ensure a fair playing field and prevent opportunities for market manipulation or arbitrage. In doing so we need to take advantage of new and innovative techniques that will reduce the costs of trading and improve the ability of compliance entities to manage their risk.

Finally, we must act quickly to seize this opportunity. Across the globe, other countries have begun to take steps towards establishing a robust carbon market. The European Union has established a market worth more than \$90 billion. Other countries – including China – have taken significant steps towards building the infrastructure to take advantage of carbon trading.

To ensure the economic and environmental success of cap and trade, we must harness the resources of the financial sector to help make the investments we need to ensure a clean energy future.

The financial sector is just one important sector of New York's economy that will benefit from a cap and trade regime. New York is also one of the nation's leading agriculture and forestry states with a diverse output ranging from wine grapes and dairy products to maple syrup, timber and apples.

Failure to act on climate change could lead to devastating results for New York's farmers, who produce billions of dollars worth of products that nourish our families and construct our homes.

A change in temperature of even a few degrees will greatly impact the temperamental crop of New York's grape producers. The expanding geographical range of invasive species such as the Emerald Ash Borer poses unprecedented risks for New York's 18.5 million acres of forestland. Our coastal regions are under threat of increased flooding and our water-rich inland regions could very well see drought.

In addition to protecting the long-term viability of the agriculture industry in New York State and throughout the nation, this legislation also promises the opportunity to realize a new revenue stream to help our farmers. This is especially important in a state like New York, where small, family-owned, specialty crop producers do not typically receive the same level of public support as farmers in other parts of the country.

Investments in methane digesters, non-food based biofuels and other methods of alternative energy generation promise to provide a new direction of growth for New York's agriculture and forestry producers and their communities. In addition to reducing our reliance on foreign oil and cutting US greenhouse gas emissions, a growth in the clean energy sectors will provide thousands of good jobs to ensure the continuing viability of our rural communities.

I will continue to work with my colleagues to ensure that New York's specialty crop producers and small forest owners are included in any discussions about offset programs. Many of the producers have been participating in voluntary initiatives and other good land management practices for many years. These individuals are innovators and pioneers, who should not be forgotten when we begin discussing incentives.

I would once again like to thank the panelists for taking the time today to come and discuss these very important issues with the committee today. I look forward to working with you as this legislation moves forward.

Senator Chuck Grassley
Statement
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
September 9, 2009; 10:00am

Thank you Mr. Chairman and Ranking Member Chambliss for calling this second hearing of the Committee on climate change. I think it's critical that all views and facts get reviewed by this Committee before we move forward on any legislation.

I also want to make a special welcome to David Miller of the Iowa Farm Bureau who will be on the panel following Mr. Gensler. Thank you for being with us today.

It's especially important that we hear directly from producers at the grass roots. Just last week we saw the positive impression that can be left on federal officials when the EPA accepted my invitation and visited Iowa.

The EPA officials heard straight from the mouths of farmers the impact that rules and regulations made by the agency can have on families and their livelihoods.

The stakeholders shared wagonloads of information, statistics, and real life examples that helped the group understand and learn the issues at the farm level. The EPA asked a lot of questions, appeared to take the message from our family farmers to heart, and promised further dialogue with our producers and stakeholders.

I hope this same process resonates with our committee members and the producers today. I like to think of farmers and ranchers as the original environmentalists of our country.

Farmers know that if they don't take care of our natural resources, their land and livestock will not be productive and their greatest resource will be destroyed.

I think farmers would be the first to endorse a realistic approach to concerns about the climate.

But if we ask our farmers to take on overly burdensome expenses, for an exercise that doesn't include an international agreement, we would be asking them to put themselves at an economic disadvantage to the rest of the world for no real environmental gain.

I look forward to hearing from all of our witnesses today about the benefits to farmers in climate change legislation, but also the real and serious challenges it poses for rural America and your recommendations to address those issues as the Senate moves forward on climate change legislation.

SENATOR THUNE'S OPENING STATEMENT:

I would like to thank the Chairman and Ranking Member for holding today's hearing. I'd also like to thank the panels of witnesses for their thoughtful testimony.

Over the coming months, the United States Senate will likely consider legislation aimed at curbing greenhouse gas emissions, primarily carbon dioxide.

Such a bill will have a dramatic impact on virtually every part of our economy.

In particular, agriculture, which is an energy intensive industry, will be greatly impacted by this legislation.

It is the responsibility of this committee to determine if America's farmers and ranchers will experience a net gain or net cost under a future cap and trade system.

Without question, ALL producers will experience increased input costs. The cost of diesel fuel, gasoline, electricity, and fertilizer will increase at time when our agriculture producers can least afford it.

However, some producers may be able to benefit from planting trees or practicing conservation management activities.

Who will bear the costs and who will reap the benefits are all but settled questions this committee must address.

Additionally, the Senate Agriculture Committee must ensure that the Commodity Futures Trading Commission is prepared to take on the additional burden of regulating what some are predicting to be a multi-trillion carbon market.

What responsibilities should be assigned to the CFTC? What have we learned from the recent financial crisis in the derivatives market? Will the CFTC be prepared for such a historic task in just a few short years?

These are all answers that must be addressed by this committee the near future.

Additionally, I am hopeful that this committee will take this opportunity to address other issues impacting our agriculture producers and our renewable fuels industry:

I believe Congress must act this year to expand the definition of renewable biomass to include federal forestlands and additional private forestlands.

I also believe we should work to address the troubling consequences of indirect land use change calculations in the expanded renewable fuels standard. This was a failed experiment that should be eliminated as soon as possible.

Testimony of W. Andrew Beckstoffer before the
Senate Committee on Agriculture, Nutrition and Forestry

September 9, 2009

My name is Andrew Beckstoffer. I live in St. Helena, a small agricultural town in the Napa Valley of California. Our family farms winegrapes, a specialty crop. Thank you so very much for the opportunity to testify before this distinguished Committee of the United States Senate regarding climate change.

There are almost 24,000 grape growers in the United States. The full economic impact of US wine, grapes, and grape products on the American economy is estimated at \$162 billion. Grapes are the highest value fruit crop in the nation and the sixth largest crop overall. Grapes are grown in more than 40 states, and they account for about 30% of the value of all fruits grown in the United States. Grapes are a significant part of the Specialty Crop segment of the U.S. Agricultural economy. Specialty Crops represent approximately 50% of the farm gate value of total plant agricultural production while occupying only about 3% of the nation's harvested cropland.

It is widely documented by medical journals that wine is good for your heart. I truly hope that is so. For sure, grapes, peaches, pears, carrots, lettuce, tomatoes, and all fruits and vegetables are specialty crops that provide essential nutrition to the American people. That is where their real importance lies.

The Napa Valley is widely known as a premium winegrape growing region. What is not so widely known is while some 9% of Napa County's land mass is devoted to vineyards, over 10% of the county's land is protected by some sort of open space conservation arrangement. Conservation and environmental sensitivity are hallmarks of our lives in the wine region. The increased tax incentives on conservation easements that Congress provided in the 2006 legislation has made a major contribution to our ability to conserve agricultural lands. In our small valley, over 1,650 acres have been placed under Conservation Easements since 2006, including 330 of our own. These are major incentives which expire this year. I hope that you will extend them beyond 2009.

WAB 9/9/09

Something else beyond nutrition and conservation is important to me. President John Kennedy said that any generation will be less known for the wars they won than for their contribution to the cultural heritage. Over the past 30 years California's fine wines have equaled in quality and often exceeded the finest wines of Europe in critical tastings. The world must now consider the American contribution to this cultural arena along with our technical, economic and military might. Winegrapes are a Specialty Crop with unique national significance.

In considering my testimony before you today I was struck by four major concerns.

FIRST, in the most recent National Farm Bill, Specialty Crop concerns received \$3 billion, just one percent of the \$289 billion approval. Specialty crops represent the most agricultural worker jobs, and produce much of America's nutrition. Somehow, considering the vast economic and nutritional value of specialty crops, I do not feel that they got a fair share in the Farm Bill. My point here is not to revisit the Farm Bill but to urge that Specialty Crops receive fair consideration as you enact Climate Change legislation.

SECOND, Specialty Crops growers are generally relatively small farmers. Our family is the largest family vineyard owner in the Napa Valley and on the North Coast of California. In total acreage we list behind only two large international wineries. On any statistic involving all farms, however, we are small farmers. That is the case with most Specialty Crop producers. We are scattered politically and geographically and do not have the organization or capacity to compete with the large program crops for adequate consideration in major legislation, such as that involving Climate Change. Without your special indulgence and careful consideration, much of this nation's nutrition engine will suffer.

THIRD, it has been widely reported that many car dealers have opted out of the "Cash for Clunkers" program because of the heavy documentation requirement on their limited staffs. We have a similarly limited staff. I would hope that the reporting requirements of any Climate change program would be held to the minimum.

WAB 9/9/09

FOURTH, USDA's Economic Research Service reports that between the years 1997 and 2002 some 8 million acres of America's farmland have been lost to agriculture due in good part to urbanization and economic pressures. In California, our population of 37 million is estimated to double in 25 years to 70 million people. This is nearly 25% of the entire population of our country today! In that short period of time, it is reported that California could lose as much land to development as we did from the gold rush of 1849 to the year 2000!

In the beautiful Napa Valley, some 60 miles from San Francisco, there is tremendous urban pressure. It is my view that winegrape vineyards here are the long-term highest and best economic use of the land. For that reason we have been able to preserve our vineyard lands. This is true in varying degrees in all agricultural lands near urban areas. These lands in many cases are relatively small Specialty Crop lands. It is widely anticipated that state and federal carbon reduction programs will increase costs for energy, fertilizer, pest management tools and other inputs as well as transportation. If winegrape growers and agriculture are not excluded from any carbon emissions cap while being able to receive credits for offsets provided, these unaddressed increased costs will result in the loss of an additional increment of agricultural lands.

Further, it is my understanding that agriculture, through plant and soil sequestration, has been identified as a priority area for "cap and trade" offsets. If the profitability of agriculture is further decreased through increased costs and competition from foreign wines made with cheap labor and government supports, that will serve to limit the availability and expansion of agriculture as an important component of any "cap and trade" program.

The winegrape quality and standards in the Napa Valley are in no immediate or short-term danger from Climate Control activity. Certainly regional statistics on average degree days do not tell the Napa Valley story. For example, 1988 and 2005 were two of the warmest years on record in California. Because of the influence of the fog brought on by our proximity to the San Francisco Bay and the coast, these were two of the coolest growing seasons in the Napa Valley. This does not mean that we are not being affected or that there will be no long-term effect. We deal in vintage years, each of which

WAB 9/9/09

seems to be different. However, something is changing overall.

For example, we are experiencing more heat spikes. Generally speaking, heat and sunlight bring beneficial effects to grape ripening and maturity. We prepare our trellises and canopy management to accept and accentuate this. When heat spikes occur, they damage the grapes, and thus we must prepare our trellises to avoid sunlight and heat—in direct contradiction to our main objective of heat and sunlight accumulation.

The nights are getting warmer. The secret of producing great winegrapes involves achieving a chemical balance between sugar, acid, and pH. Sugar is accumulated during the sunlight hours, acid by the cool nighttime temperatures, and pH at both times. Climate change is increasing our nighttime temperatures, which at this time has an unknown effect on grape balance and quality. We need research to show these effects and the interaction of our different vineyard management systems. I understand that much of the carbon sequestration research has been done on annual crops. Our vines with a 20 to 40 year lifespan have a significantly different carbon footprint, and their relationship to annual crops should be analyzed.

Another area where Climate change is beginning to affect us is pest infestation. The disruption in the ecosystem is producing new pests and mutations and vine diseases that we do not yet understand. This could have a major effect on our ability to limit pesticides.

For reasons of economics, fruit quality, and soil and water conservation, we have, over the past many years, drastically reduced our tractor usage in the vineyards. In the 1980s Napa Valley vineyards were infested with a devastating root disease. In the 1990s we replanted almost the entire valley with new vines and techniques designed to improve grape quality, reduce vine and soil manipulation, and improve conservation of natural resources. At Beckstoffer Vineyards we use only about 50 pounds per acre of nitrogen fertilizer per year. This is far less than most crops. We limit our irrigation practices for reasons of fruit quality and use efficient drip irrigation when we do irrigate. We make extensive use of cover crops to host beneficial insects and limit pesticides as well as reduce tillage to limit

WAB 3/9/09

moisture evaporation. We in the winegrape business have for many years been adapting practices that sequester carbon. Hopefully, these early practices will be recognized in any potential carbon market or offset program.

Most of what we have been doing and currently do to reduce greenhouse gases is done to achieve fruit quality, to improve soil and water conservation, and for economic reasons. Only a very foolish farmer, without consideration of future generations, would not seek to save his soil and his water. As concern for Climate Change intensifies, our adherences to those practices and our curiosity about how to improve them increases.

California winegrape growers are national leaders in utilizing and promoting sustainable practices.

We at Beckstoffer Vineyards have participated along with 1,500 other growers representing 68.3% of the total 523,000 California winegrape acres in the California Sustainable Winegrowing program. This program provides self assessment of sustainable practices that are environmentally sound, socially acceptable and economically feasible, and offers concrete suggestions of how to improve. We are also in the process of converting two-thirds of our vineyard acreage to Certified Organic status.

Finally, it is my belief that we as Americans made great progress in the 20th Century. Amazing things were done in the fields of transportation, communications, armament, technology and agriculture. We should be congratulated! But in doing so, in many cases, we dried up or polluted our water, eroded our soils, and fouled our air.

Your hearings today are an obvious recognition of these facts. In the 21st Century we must continue to make progress, but preservation, conservation and environmental sensitivity must be a new requirement. We in the winegrape business are anxious to play under those rules. Given our scattered political voice and historic small share of economic and policy incentives, however, we do need your careful consideration and indulgence as you prepare a policy for Climate Change. I thank you again for

allowing me to testify today, and for your interest in the winegrape industry. I look forward to your help in allowing us to sustain our contribution to the national health and welfare.

Washington DC testimony 1sep109

WAH 9/9/09

**PRODUCER PERSPECTIVES
AS THEY RELATE TO DAIRY FARMS
AND
GLOBAL WARMING**

Chairman Harkin, Senator Casey and Agriculture Committee Members:

I want to thank you for the opportunity to speak before you today about the issue of global warming. I do not come here today as an expert on global warming, but to tell you some of the great things that happen on Brubaker Farms, and that I believe we can have an impact on the atmosphere and global warming.

To begin, I would like to speak with you about Brubaker Farms Dairy and dairies in general and how they can profit from the product (manure), which, in some cases, is thought of as a liability rather than an asset.

I like to think of myself not just as an environmentalist, but also as a business leader where I can lead in the local community and represent dairy farmers on state and national issues. Please refer to my short bio which I believe you received.

Brubaker Farms of Mount Joy, Pennsylvania, is owned by my wife and me, in partnership with our two sons, Mike and Tony. My father purchased the farm in 1929 and started the operation with eight (8) cows. My brother and I purchased the farm from our father in the early 60's, at which time the animal operation consisted of 18 cows. In the early 90's, my two sons graduated from college and wanted to come back to the farm to be a part of the operation. At that time, my brother sold his interest in the farm to me and my sons, and we entered in to a formal partnership to manage Brubaker Farms. At the time the partnership was formed, the Brubaker animal operation consisted of 200 cows. The farm now has over 800 cows, 600 young stock, and also a 250,000 bird broiler chicken operation per year. These expansions to the operation allow it to provide the necessary income to sustain the three farm families that now rely on it for their economic well-being.

We have developed an operation that is both financially stable and is an important part of the local economy. We have taken actions to ensure that the site is maintained as a working farm in the future through participation in the Pennsylvania Farmland Preservation Program. In order to address farm commodity price issues, farm expenses, and family financial needs, we are ready

to make the necessary business decisions to ensure that the farm will continue to be economically viable in the future. The farm is our family business and the economic viability of the operation is critical in order to allow it to continue to be an effective business well in the future, and for it to be an economically sustainable family enterprise.

The most recent project we have completed is a manure digester. We are excited about what this new addition means to our farm and to the energy security of Lancaster County, Pennsylvania and neighboring community. At the present time, our digester is generating approximately 4-5 mw (megawatts) of electricity a day. Most of the electricity that we generate is being sold back to the local electric utility company, PPL. We have the capability of producing enough electricity to supply approximately 150-200 homes a day.

Key to the methane production is the cows and heifers. The manure flows by push and gravity to a recovery pit where it is pumped into a large lagoon of approximately 700 thousand gallons and where bacteria in the lagoon converts volatile solids in the manure into biogas or methane gas. The lagoon is completely covered and insulated. The gas flows underground into the generation building which houses a large Guascor engine and generator capable of producing 225 kw (kilowatts).

Now, I would like to speak to some of the advantages of a methane digester:

- Reduces the strain on the PPL grid
- Reduces the need for electricity produced from fossil fuel power plants
- Reduces pathogens in the digested manure
- Separates the solids from liquid and recycles the solids for bedding
- Reduces the odor by 75 to 90% after digested
- Fly larvae are killed by the digester, resulting in less flies
- Reduces methane and other greenhouse gases into the atmosphere
- Weed seeds killed in digested manure which in turn can reduce chemical use
- Selling electricity to the local power company as renewable energy
- We are permitted to add food by-products that can be metered to the manure which makes extra electricity.
- Possibility of partnering with cafeterias to use food scraps added to manure rather than land filling which makes electricity. In turn, this can result in a profit to the

farmer.

- Methane is one of the potent greenhouse gases. It is 20 to 23 times more powerful in trapping heat in the atmosphere than carbon dioxide.
- We make a profit from the sale of carbon credits to industry or individuals who need or want to offset emissions.
- As a greenhouse gas, methane differs from carbon dioxide in an important way. Methane remains a climate-change threat in the atmosphere for a number of years.
- The reduction in the methane from our digester can lead to a slowing of climate change.
- Use of the manure after it goes through the digester is readily available to plants for plant food, which, in turn helps prevent leaching and a chance for run-off.

As we all know, in this critical time, the dairy farmer has some financial difficulty. Some of the things we talked about today could help the dairy-livestock producer. As a side note, I would be happy to offer suggestions or ideas that could help correct the dairy situation.

I believe that, over the next ten (10) years, environmental and renewable energy issues are going to be some of the biggest challenges for agriculture and farmers. Using state and federal funding and loan assistance for this project and our new solar project to produce electricity for 150 homes on the roof of our new heifer barn helps Brubaker Farms make our goals a reality.

I believe investing in projects like these is good for the future of the dairy industry's economy, environment, and the entire world.

I will be glad to answer any questions you might have.

Thank you again for the opportunity to speak today.

Luke Brubaker
September, 2009

STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
September 9, 2009

Good morning Chairman Harkin, Ranking Member Chambliss and members of the Committee. Thank you for inviting me to testify today regarding cap-and-trade legislation before Congress. My testimony will focus on the Commission's experience regulating emissions trading markets and how we can apply that experience to trading in government-issued greenhouse gas allowances and offset credits. In the event that Congress passes cap-and-trade legislation, the Commodity Futures Trading Commission has the necessary expertise to regulate trading in the expanded carbon markets.

Before I turn to the carbon markets, I am pleased to report to you that the CFTC has been very active since the last time I testified before this Committee. Since then, we have held three hearings into whether or not to set position limits in the energy markets like we do in the agriculture markets. We have worked with the Treasury Department to deliver legislative language to the Congress that would regulate over-the-counter derivative markets. We have revised a no action letter and reached an agreement with the United Kingdom Financial Services Authority to enhance our oversight of a foreign board of trade. We have withdrawn two additional "no action" letters that permitted traders to exceed position limits in some of the agriculture markets. We have improved our transparency efforts by disaggregating the data in

our weekly Commitments of Traders reports. And just last week, we held unprecedented meetings with the Securities and Exchange Commission on how we can better harmonize our regulatory structures to most benefit the American public.

Over the past year, we have witnessed the consequences that regulatory gaps and inconsistencies can have on our financial system, the economy and the American people. As Congress moves forward with potential cap-and-trade legislation, I believe it should ensure that there is a comprehensive regulatory framework over the expanded carbon markets – both the futures market and the cash market – without exception.

Proposed cap-and-trade initiatives would impose a ceiling on the total amount of greenhouse gasses that covered entities can emit and expand the market for pollution rights, which are known as “allowances.” An allowance is a limited authorization by the government to emit a quantity of carbon dioxide equivalent. The allowance could be traded, used by regulated parties to comply with emissions caps or potentially banked. Along with allowances, cap-and-trade programs for greenhouse gases utilize “offset credits” – credits given for activities that reduce, trap or sequester carbon.

It is crucial to ensure that the carbon market functions smoothly, efficiently and transparently. Effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are five regulatory components of carbon markets that I believe should be considered:

1. Standard setting and allocation;
2. Recordkeeping (maintaining a registry);
3. Overseeing trade execution system;
4. Overseeing clearing of trades; and
5. Protecting against fraud, manipulation and other abuses.

The first two components – the actual allocation of allowances and offset credits, and recordkeeping (other than recordkeeping of the trades) – fall within the expertise of other agencies. In other words, others are better equipped to regulate the “cap” part of “cap-and-trade.”

For example, the EPA currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain, NOx Budget Trading and Clean Air Market Programs. On a smaller scale, a conglomeration of ten states in the northeast and mid-Atlantic form the Regional Greenhouse Gas Initiative and issue allowances on greenhouse gas emissions. In each case, other entities issue allowances and maintain the registry. The constant, however, is that the CFTC regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the “trade” part of “cap-and-trade.”

Specifically, we have broad experience in the latter three components of carbon trading: regulating trade execution systems and clearing of trades and guarding against fraud, manipulation and other abuses. The Commission already oversees trading and clearing of futures and options contracts based on sulfur dioxide, nitrogen oxide and carbon dioxide

allowances and offsets listed on the New York Mercantile Exchange and the Chicago Climate Futures Exchange. Additionally, just last month, under direction from Congress in last year's Farm Bill, the Commission put out a proposed determination for public comment to classify the Carbon Financial Instrument contract traded on the Chicago Climate Exchange as a significant price discovery contract. This would give the CFTC full oversight authority over the contract, giving us additional experience regulating cash emissions contracts. The Commission has abundant experience in the regulation of centralized marketplaces, and should Congress seek to regulate cash markets for emission instruments, the Commission is well-suited to carry out that function.

In most respects, emissions contract markets operate no differently than the other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, soybeans, treasury bills or natural gas – presents its own unique challenges, the regulatory scheme is essentially the same. Carbon markets have similarities to several different markets that fall within our regulatory authority. For example, carbon allowances and offsets are similar to agriculture commodities in that there is a yearly “crop” and important programmatic regulations governing the nature of the product. At the same time, carbon contracts have similarities to financial products. For example, government-issued allowances and offset credits would be similar to Treasury-issued debt instruments. Futures contracts on Treasury debt are among the most actively traded CFTC-regulated products.

The emissions trading markets that the CFTC currently regulate are small relative to the expected growth of the carbon market as a result of cap-and-trade legislation. Still, the agency has the expertise to apply the same oversight to the much larger, national and mandatory market.

The Commission has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, that products are designed to minimize potential manipulation and that exchanges comply with the law and regulations. The Commission's compliance staff actively monitors operations to ensure that exchanges are enforcing their rules and that customers are protected from abusive practices. The oversight of clearing is an integral part of the CFTC's regulatory structure. The Commission has extensive experience and a well-established program to ensure derivatives clearing organizations and clearing firms have safeguards to ensure orderly clearing and settlement of transactions and safekeeping of customer funds. Our surveillance staff keeps a close eye for signs of manipulation or congestion and determines how to best address market threats. We have the authority to set and enforce position limits, and our enforcement staff is actively prosecuting cases. In the past year, the CFTC has expanded the scope of its existing energy advisory committee to create the Energy and Environmental Markets Committee, which significantly enhances the CFTC's ability to anticipate and address the full panoply of regulatory issues pertaining to emissions trading markets.

The CFTC has wide-ranging transparency efforts designed to provide as much information to the American public as possible. Specifically, the Commission publishes weekly Commitments of Traders reports, which, starting last week, include disaggregated data to more

accurately depict the makeup of the futures and options markets. The Commission also publishes quarterly data on index investment, a "This Month in Futures Markets" report and annual financial data for futures commissions merchants and futures industry registrants.

Should Congress pass cap-and-trade legislation, the CFTC would work with other regulators and market users to ensure that all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis. With immediate registry of trades, it will be easier for regulators to identify manipulation in the markets.

The CFTC, however, would need additional resources for new staff and technology to effectively regulate the expanded carbon markets. The Commission is just this year getting back to the staffing levels that it had in the late 1990s. Since then, the markets grew five-fold and the number of contracts grew six-fold, but the agency's staff was cut by more than 20 percent. To take on additional oversight responsibilities, we will continue to work with this Committee and the Appropriations Committees to secure additional resources.

As Congress moves forward and possibly enacts cap-and-trade legislation, I look forward to working with this Committee to ensure that the new markets are comprehensively and effectively regulated. The CFTC is the exclusive regulator of futures markets. I believe that we have the expertise and experience necessary to help regulate the growth in carbon futures and cash markets that will occur if cap-and-trade becomes law. We must protect against the same

hazards in the carbon markets that we currently guard against in other commodity futures markets: fraud, manipulation and other abuses.

Thank you for inviting me to testify today, and I look forward to your questions.

Testimony of Joseph R. Glace
Vice President and Chief Risk Officer, Exelon Corporation
Before the Committee on Agriculture, Nutrition, and Forestry
United States Senate
September 9, 2009

Mr. Chairman and Members of the Committee:

My name is Joe Glace, Vice President and Chief Risk Officer of Exelon Corporation. Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, ComEd, which serves northern Illinois including the city of Chicago, and PECO Energy, which serves southeastern Pennsylvania including the city of Philadelphia, together serve 5.4 million customers, or about 12 million people – more than any other company in the United States. We have fossil, hydro, nuclear and renewable generation facilities. Our nuclear fleet is the largest in the nation and the third largest in the world. I have worked in the energy field for 29 years. At Exelon, I am responsible for leading our risk management function, including the identification, assessment and monitoring of market, credit, and operational risks.

In my testimony today I want to highlight Exelon's:

- Support for comprehensive climate legislation;
- Opposition to requiring all trading, derivatives, and hedging activities to be conducted on exchanges;
- Support for expanding the CFTC's jurisdiction to the new market for carbon allowances, including the over-the-counter (OTC) market; and
- Support for reporting requirements for OTC transactions in the carbon markets

Exelon was an early and vocal advocate of climate change legislation. We have testified in favor of passage on several occasions. Our CEO, John W. Rowe, first testified in favor of addressing climate change by means of a carbon tax in 1992. We are pleased that the House has passed a comprehensive climate and energy bill and look forward to working with this Committee and the Senate to pass comprehensive, cap-and-trade legislation this year.

Exelon supports an economy-wide bill with realistic targets and timetables, an effective cost containment mechanism, such as a cost collar, and allocating electric sector allowances to regulated local electric utilities with a requirement that the value represented by the allowances is used to provide benefits to customers.

To better understand Exelon's views regarding regulation of the carbon market and the concerns that are the intended focus of this hearing, I think it is important to explain briefly Exelon's overall approach to commodities trading. We are not speculators. We use commodities trading to reduce the price risk we face as an electric generation company. That is, our primary objective is to reduce the risk to our revenues that we would face if we were completely subject to the sometimes sharp fluctuations in short-term, spot market power prices.

Let me delve into this a bit further. A substantial majority of our generation fleet is located in the geographic footprint of what are known as "regional transmission organizations" or RTOs. RTOs are regulated by the Federal Energy Regulatory Commission or FERC. RTOs operate competitive markets for wholesale energy and capacity. Accordingly, unless Exelon does something about it, Exelon is completely exposed to the ups and downs of the short-term, spot market energy prices in those markets. That is, we could make a lot of money if the spot prices turn out to be high, or lose a lot of money if they turn out to be low. Because we are not speculators, however, we are not willing to take that gamble. Instead, our business model is to lock in, or hedge, the price we are paid for the electricity we generate.

We do this by buying and selling energy products that are available in the commodities markets. For example, we might sell an amount of electricity for one agreed price for all hours in the summer months of June through September. We will then know that we will always get that price for that amount of electricity during those four months. We forego the prospect of getting higher prices absent the sale, but, and more importantly, we avoid the risk that prices will fall below the fixed price we are paid by the buyer of the electricity. We also can do the same thing with respect to the fuel we buy to run our

plants. We might transact in the OTC market for coal to lock in our fuel cost for our coal plants.

An increasingly large percentage of our hedging transactional activity is in the markets for purely financially-settled swaps and options, or derivatives, where the underlying reference commodity is usually electricity, natural gas, oil, or coal. For example, we might enter into a swap pursuant to which a counterparty pays us \$25 per megawatt for 50 megawatts of electricity per hour for every hour in the month of July, and we pay the counterparty the spot market price that we are paid by the RTO for the electricity we have actually generated. The result for us is that we are guaranteed that we will be paid \$25 per megawatt of electricity – no more and no less. The counterparty makes money if the spot prices we pay it turn out to be higher than \$25 per MW, and loses money if the spot prices are lower than \$25 per MW. No physical electricity actually changes hands; rather, only an exchange of revenue streams happens, based on an underlying variable commodity price (the spot market price of power). Exelon gets a fixed revenue stream and the counterparty gets, and takes the risk associated with, a variable revenue stream determined by the spot market price of power – a risk that Exelon would otherwise take but for the transaction.

Our customers benefit from this hedging and trading activity. We are in a position to agree to longer term power sales contracts with both wholesale and retail customers; the price terms under those contracts are in large part possible because of the relative price stability hedging provides to our portfolio. It is our experience that retail customers in particular want prices for power sales to be stable rather than subject to the fluctuations of the spot market. Without hedging and trading we simply would not be able to do that.

One of the principal concerns many have expressed with adopting a carbon control regime is how it will affect our fragile economy. We at Exelon believe that the economic impact of a comprehensive program will be manageable if the legislation includes the elements outlined above and if it provides the mechanisms necessary for a robust allowance trading program, including derivative products derived from those allowances. Simply put, a properly regulated, robust trading program, plus liquid trading

markets, will help control the overall cost of the program. That is why it is important to view the issues before this Committee, which are the topic of today's hearing, from the customer's perspective. What steps should the Congress take to effectively regulate and ensure the integrity of carbon trading markets without imposing undue costs on consumers?

Our strongly held view is that any regulatory reform of the commodities markets should ensure that the products which we use to prudently hedge our business risks remain available to us and at a cost that is comparable to the costs we face today. This means that we believe it would be a mistake to force most, if not all, derivative hedging transactions like the ones I just described to exchange-traded platforms such as the New York Mercantile Exchange (NYMEX), or to require that all bilateral or OTC derivative transactions be cleared through exchanges like the NYMEX. We enter into futures contracts on the NYMEX, and also clear some transactions with NYMEX and other clearing platforms, but a substantial component of our derivatives hedging program is in the OTC market without clearing.

Transacting on exchanges is much more expensive than in the OTC markets because it requires posting of substantial amounts of cash as collateral. This is one reason we do not – in fact cannot – conduct all of our hedging activity on exchanges. The OTC market enables us to transact with creditworthy counterparties without having to post potentially huge amounts of cash collateral but also without taking on any materially greater amount of default risk. We can more efficiently husband our cash by using other forms of payment security and collateral to secure some of our risks bilaterally in the OTC markets, including letters of credit, payment guarantees, and pre-payment arrangements. Were we to have to move all of our hedging to exchanges, any move in price could require additional cash outlays in the hundreds of millions of dollars range, and possibly even in the billions. This, in turn, would mean that we would have to charge substantially more for our product – electricity – which means our customers would have to pay substantially more for this vital commodity.

The same is true, albeit indirectly, of any requirement to clear OTC derivatives. Counterparties will be loathe to clear materially larger volumes than they do currently, because once cleared, their counterparty becomes the exchange, and the more costly posting requirements applicable to exchange-traded transactions would then kick in.

Another drawback of limiting hedging activity to exchanges and clearing platforms is that these entities will only offer futures for, or provide a clearing platform for, a standardized set of products. Exelon enters into customized transactions that get us a lot closer to completely eliminating the particular price risk we are trying to hedge than would one of the standard products that would regularly trade on exchanges.¹

To draw the obvious conclusion – power prices will be higher, meaning that consumers will ultimately pay more than they would otherwise, if companies like Exelon are forced to do all of their hedging on exchanges and clearing platforms.

Exelon is not alone in its opposition to requiring all transactions to go through exchanges. I want to draw your attention to a recent letter sent to all senators by a large group of trade associations representing the energy sector, rural electric cooperatives, and consumer groups, a copy of which is attached to this testimony. It raises the same concerns about the increased costs of dealing primarily through exchanges and clearing platforms that I have explained, and therefore shows that there is a broad consensus among energy suppliers and consumer associations that forced exchange trading and mandatory clearing is not the way we should address the concerns that this committee is tackling.

¹ As noted in a recent briefing paper published by the Pew Economic Policy Department, “[e]conomic efficiency is harmed if those with commercial needs for hedging are forced entirely into standard derivatives positions that are relatively poor hedges, or if derivatives markets are unable to innovate along with changes in the economy.” Darrell Duffie Dean Witter Distinguished Professor of Finance at Stanford University’s Graduate School of Business, (2009), “How should we regulate derivatives markets?,” Pew Briefing Paper # 5, Pew Economic Policy Department, p. 18. See http://www.pewfr.org/admin/task_force_reports/files/Pew_Duffie_Derivatives.pdf

Exelon believes there are better ways to protect commodity markets from the risk that some entities may try to manipulate them, and from the more fundamentally systemic risk that the country faced as a result of the unregulated and frenzied speculative trading that went on in the credit default swap markets. To explain what we think would make the most sense, I now turn to the question at hand – what to do about the coming market for carbon emissions allowances.

The carbon cap and trade proposal that Exelon supports, and that is contemplated in the legislation passed by the House, will immediately result in a large, new market for carbon allowances. One of the critical electricity consumer-protection features of the House-passed bill is the provision that would require allocation of 30% of the allowances - which recipients would receive at no cost - to regulated local distribution utilities. This proposal has very broad support, ranging from investor-owned utilities, electric cooperatives, and municipals, to state regulators and consumer advocates. The local distribution utilities are not “covered entities,” to borrow a term of art from the House bill; that means they will have no compliance obligation, and therefore will not “need” the allowances they receive for compliance purposes. The utilities, however, would be required to ensure that the benefit of those allowances goes to their customers. Every state, and the District of Columbia, has a public utility commission, or PUC. The PUCs regulate the local utilities and have authority to ensure that the customers do, indeed, benefit from the allowances. In the case of Exelon, our distribution utilities, PECO and Com Ed, will sell the allowances, and then the Pennsylvania and Illinois PUCs will oversee the use of the proceeds to ensure that they will benefit customers. One way they will consider to accomplish this result will be to use the revenues to reduce customer rates. They could also require the revenues to be used for financial assistance to customers who need it or energy efficiency programs.

Generation-owning entities like Exelon, as well as other emitters, will need to procure allowances to comply with carbon emissions caps; we and other generators will be covered entities. In this regime, the cost of carbon allowances will be a cost of doing business for generators. It will be just like the cost of gas, oil, or coal – an input that is necessary to enable us to make and sell our

product. And Exelon will need to hedge the price risk associated with that product. That will mean that Exelon will want to have as wide a range of options as it currently does to hedge its fuel price and power price risks, meaning the full array of both exchange-traded and OTC offerings that now exist.

We recognize, however, that in this new market as in others, there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps that can tempt unscrupulous traders to manipulate markets and force prices above appropriate market levels.

That is why we support the expansion of the CFTC's jurisdiction to the new market for carbon allowances, including the OTC market that will certainly develop. This should allay any concern that speculators could artificially drive up the price of both the derivatives used to hedge the cost of carbon allowances in OTC markets, and the price of the allowances as such. The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to OTC markets, and perhaps revised and refined to ensure that they provide to the CFTC the tools it needs to prevent manipulation.

For the same reason, Exelon also supports the adoption of new reporting requirements for OTC transactions in the market for carbon allowances. The CFTC has to have access to information about transactions to enable it to fulfill its regulatory oversight and enforcement function. Also, the obligation to report, as such, will be a powerful deterrent to would-be manipulators.

In addition, Exelon appreciates the critical nature of the country's need to prevent, for all time, the kind of crisis we faced last year, which revealed to all that unbridled trading activity could pose potentially catastrophic systemic risk. Accordingly, in addition to comprehensive transaction reporting requirements, Exelon supports the development and establishment of rules and guidelines that the CFTC would use to "stress test" the riskiness of the portfolios of major swap dealers and participants active in the carbon markets,

and in particular of those whose primary business, unlike Exelon's, is to make markets and trade derivatives for their own account.

I appreciate the Committee's invitation to testify today. You are dealing with an extraordinarily complicated subject area. I hope that I have provided you with a sense of why it is important to ensure that there is effective oversight of the emerging carbon markets while at the same time guarding against over-regulation that would result in higher costs for companies like Exelon and in turn for our customers. I would be pleased to answer any questions you may have.

Joint Association Letter Regarding the OTC Derivatives Issue

July 10, 2009

Dear Senator:

The undersigned energy supplier and consumer associations represent all the major segments of the electric power and natural gas industries serving virtually all of the consumers in the United States. We are writing to express our concern with certain aspects of proposals to address oversight and transparency of over-the-counter (OTC) energy markets. While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets and to prevent excessive speculation, it is essential that policy makers preserve the ability of companies to access critical OTC energy derivatives products and OTC energy commodities markets. We rely on these products and markets to manage risks to help stabilize and keep energy costs low for consumers.

The members of the associations represented on this letter use the OTC markets to hedge a variety of risks associated with energy production and fuel costs. We use OTC contracts to help insulate our business and customers from excessive price volatility.

Specifically, we are concerned with proposals to impose mandatory clearing of all OTC transactions, as well as requirements to force OTC derivative transactions to be moved onto an exchange. We believe that such proposals would significantly increase costs for companies seeking to hedge risks through OTC products, as well as greatly limit, or eliminate altogether, needed customized products used for risk management for the following reasons:

- The high cash margin requirements of a clearinghouse or an exchange would significantly increase transaction costs, and tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industries need to invest billions in new energy infrastructure.
- At the same time, since clearinghouses and exchanges require a high level of standardization and liquidity in the derivatives and commodities products traded, we believe that such proposals would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks. For example, in the case of electricity, the prerequisites for standardized and centralized clearing are missing, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets.

Ultimately these increased costs and risks will be borne by all consumers. We believe that there are far better ways to accomplish the goals of greater transparency and effective regulatory oversight of OTC energy derivatives and commodities markets without mandatory clearing or forcing these products to be moved onto an exchange. We would welcome the opportunity to discuss these issues with you.

List of supporting associations:

| | |
|--|---|
| American Gas Association | Interstate Natural Gas Association of America |
| America's Natural Gas Alliance | Large Public Power Council |
| American Exploration & Production Council | National Association of Manufacturers |
| American Public Gas Association | Natural Gas Supply Association |
| American Public Power Association | National Rural Electric Cooperative Association |
| Edison Electric Institute | US Chamber of Commerce |
| Electric Power Supply Association | US Oil & Gas Association |
| Independent Petroleum Association of America | |



**Statement of the
Iowa Farm Bureau Federation**

**To the Senate Committee on Agriculture, Nutrition & Forestry
Full Committee Hearing**

**Global Warming Legislation: Agricultural Producer Perspectives
and Trading Regulation Under a Cap and Trade System**

Presented by

**David Miller, IFBF Director of Research & Commodity Services
and Chief Science Officer AgraGate Climate Credits Corporation**

Wednesday, September 9, 2009 — 10:00 a.m.

216 Hart Senate Office Building

Thank you very much for this opportunity to present testimony and discuss issues regarding market structure and market performance as it pertains to carbon markets. My name is David Miller and I am the director of research and commodity services for the Iowa Farm Bureau and the Chief Science officer for AgraGate Climate Credits Corporation, an affiliated company of the Iowa Farm Bureau. AgraGate is one of the leading aggregators of carbon credits from U.S. agricultural and forestry lands under the existing protocols of the Chicago Climate Exchange. We provide the means for thousands of farmers and landowners across more than 30 states to access the existing voluntary carbon markets. We help them enroll, quantify and verify their potential carbon offset credits so that they can be registered and marketed to entities that have a need for such.

I also farm. On our 400 acre farm in southern Iowa we converted to continuous no-till in order to qualify to earn carbon credits under CCX rules. I am one of thousands of U.S. farmers, forester and ranchers, who work more than 16 million acres, that have been paid for providing environmental services through the CCX enrollment, verification and carbon credit sales process. (See Figure 1) Our credits can be sold to any of the 400 plus legally-approved members of CCX, including companies, governments and universities that legally commit to reduce their emissions, as well as investors and others. While I have served for over six years on various governing committees at CCX (There have been more than 300 committee/subcommittee meetings in the past 6 years – the CCX system is not “set it and forget it.”), I am speaking today on behalf of AgraGate and Iowa Farm Bureau.

Occasionally, we have been asked why all of the credit registrations we have done have been on the Chicago Climate Exchange. The simple answer to that is that CCX has the only protocols that are “workable” for production agriculture and private forest lands. Various aspects of the protocols of other registries have design elements that limit their acceptance by offset providers.

Market design and structure matter and are critical to market performance. Some of the items that I would like to discuss today include market transparency, offset protocol standards and the critical need for fungibility of compliance offsets.

Pricing Transparency

Market transparency is critical to smooth operation of a carbon market. Transparency means that not only must there be a clear enumeration of what criteria are used to define offsets, but that there must be mechanisms in place so that prices (bids, offers and sales transactions) are publically reported and readily available. The only market that currently offers that transparency is the Chicago Climate Exchange. The electronic trading platform was very transparent about bids, offers and actual transaction prices. On the exchange, all of the compliance instruments were equal and fully fungible. Under that condition, the members of the CCX that needed compliance credits could buy excess allowances or any type of offset that was registered with the exchange and know that their compliance commitment would be met. Unfortunately, that pricing transparency has been sharply curtailed. Under the provisions of H.R. 2454 (The American Clean Energy Act of 2009), there is language that suggests that domestic offsets from current registries may be exchanged or recognized in the federal regulatory program, but it does not provide specific indication that allowances from CCX will be recognized. This

differentiation has resulted in all offset transactions moving to bi-lateral, privately negotiated trades where the buyer can be assured that they will receive offsets rather than any CCX compliance instrument as might be the case on the electronic platform.

To improve transparency, CCX rules have been updated to require that all privately negotiated trades be reported to the exchange and they post these trades daily. But, the bid-ask spread has widened significantly and the market has fragmented such that the offsets from soil are valued differently than the offsets from forestry which are valued differently than the offsets from methane destruction, etc. In fact, there is even differentiation of value based on the geographic location of the offset project. This has increased the transaction costs associated with marketing carbon offsets and has reduced the net returns to the actual offset project owner.

Regulatory uncertainty is now harming the thousands of U.S. farmers and companies who have taken the lead in building rules-based carbon markets. It is extremely important to provide a smooth transition for those who are making emissions reductions in CCX and other verified programs so that continued progress on their part can be made to reduce emissions.

Other carbon registries have little or no pricing transparency. There is no public record of the bids, offers or transaction values of offsets registered and retired on the Climate Action Reserve, the APX-Voluntary Carbon Standard or CDM projects. The lack of market pricing transparency means there is much less information available to market participants and tends to shift undue market power to large traders to the detriment of project owners and smaller participants.

Fungibility of Compliance Offsets

Fungibility of compliance offsets, where a registered offset credit equals a registered offset credit regardless of the source of the credit, is a market design characteristic that is essential if the transaction costs of the carbon market are to be minimized. Fungibility of offsets will foster efficient market operations and enables transparency since it is conducive to trading of the compliance instruments on electronic exchanges with full pricing transparency.

"Term Credits" as delineated in H.R. 2454 are not fungible compliance instruments. They only delay compliance obligations. They do not satisfy compliance obligations. They are an inferior product and based on the experience of temporary credits under the European trading system, they will have little or no value. It is extremely problematic that H.R. 2454 has relegated all soil sequestration offsets, by design, to the class of term credits. It is neither necessary nor desirable from a market design perspective to address the issue of permanence in this manner. There are better ways to address that issue and a discussion of a better approach is contained in our written comments. In our analysis, we believe term credits will be highly discounted by the marketplace, especially if the expectation is that credit prices in the future will be higher. Relegating soil offsets to term credits will minimize the participation of working farmlands in carbon offset markets.

Offset Design Criteria

According to the EPA analysis, biological sequestration represents upwards of 90 percent of the expected total offsets during all timeframes outlined in the ACES legislation. Thus from a macro perspective, biological sequestration is the linchpin of an effective domestic offsets program for the agriculture and forestry sections. Bio-sequestration offsets are the only means by which domestic offsets can deliver low cost, near term and high volume GHG reductions, all critical requirements in allowing the uncapped sectors of the economy to facilitate the capped sectors' transition to a low-carbon future.

Offset sources need clear, simple, protocols, or rules, which define eligible practices and associated record keeping. The cost of perfect information is usually too high. So, reasonable compromises, including conservative carbon accumulation rules, must be employed

Design criteria for offset protocols can "make or break" the viability of agricultural and forestry offsets as real tools in the effort to reduce atmospheric carbon. To be viable, offsets must be designed for "working lands." It is the active growing of crops, grass, and trees that will take the carbon from the atmosphere in the first place. The income from these production activities is essential to the sustainability of the carbon-sequestering activity. Private farmlands and forests are not preserves – and we don't want them to be if we want to have affordable food, fiber and fuel. Income from carbon offset credits is quite likely to be the incremental incentive that will entice participants to take on the costs and liabilities that compliance with multi-year offset protocols will require. But the carbon offset income is highly unlikely to be sufficient, by itself, to sustain the dedication of the land to these carbon sequestering activities. No-tilling crops like corn, soybeans, barley or wheat will not only sequester carbon in the soil, enhancing that resource for generations to come, but also helps the world by producing food on the most productive lands in the world rather than having fragile lands degraded by subsistence agriculture.

But, to be a workable part of the solution, carbon offset protocols must work within the framework of existing agricultural markets. Length of contract matters. In Iowa, more than 60 percent of the farmland is rented by the operator with the vast majority of that land on one-year renewable leases. In our experience of working with farmers on carbon offsets, the number one reason why a farmer would NOT participate in a carbon offset program is the length of contract. Even the 5-year contract that we use in connection with the CCX protocol is long enough that many farmers believe it adds enough liability that they cannot participate. It is difficult to commit to being fully liable for reversals that can create backward looking liability for 5 years when the lease agreement that governs control of the land is for a shorter period of time. And it is unlikely that the emergence of a carbon market will result in a wholesale change in landlord-tenant relationships and the structure of land leases. We have looked at the proposed protocols of some other registries. Some of these protocols have single term length of commitment from 20 years to 199 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long. We believe that 5-year contracts for soil sequestration (with the option of renewing the contracts) are workable, but even minimum contract length of 5-years will significantly reduce participation by active farmers.

The 15-year contract length for managed forests is of sufficient length that it is a major deterrent to participation by private landowners. Sure there are some forest preserves and special cases

where 100-year contracts can be entered into. But our experience is that very few private landowners are willing to do so -- and the vast majority of the carbon-sequestering opportunities are on private lands. We have looked at the proposed protocols of some other registries. Some of these protocols have single term length of commitment from 20 years to 100 years. Our experience is that farmers and private forestry landowners are very reluctant to sign contracts that extend that long. We believe that 5-year contracts for soil sequestration (with the option of renewing the contracts) are workable, but even minimum contract length of 5-years will significantly reduce participation by active farmers.

Generalized quantification methodologies are a very effective and low-cost way to quantify soil sequestration offsets. (This is the methodology contained in the CCX soil and rangeland protocols.) Soil sequestration results from the carrying out of specific practices in conjunction with crop production. While the exact quantity of carbon that is sequestered varies across the landscape due to variations in soil characteristics, plant growth, climatic conditions, etc., across a large number of acres the actual amount of carbon sequestered will be the average of the area times the number of acres carrying out the appropriate practices. There is substantial data from a number of highly controlled research plots that provide great insight into what the average rate of sequestration is for land resource regions. Granting offsets at the average rate for a defined region (adjusted for the permanence reserve) guarantees statistically that the number of credits granted were a true representation of the actual sequestration that has occurred. Under this approach, any individual acre may actually sequester more or less carbon than the rate that is used in the generalized approach. In fact, it is quite likely that the distribution of a large number of acres will have the characteristics of a normal distribution with equal likelihood of actual sequestration rates that are above and below the average.

Don't be fooled by the "illusion of accuracy" that exists when credits are granted based on site-specific soil sampling. Generalization of site-specific soil samples and granting credits based on the results of such samples introduces much error and variation into the crediting process. The reality is that there is likely to be as much variation within an 80 acre field as there may be across a region. Using a generalized quantification approach with wide-spread participation eliminates the potential for selective sampling and skewing of the results based on sampling procedure. Plus, the use of a generalized quantification approach allows for use of satellite technology for compliance verification which can greatly reduce the costs of verifying compliance. Is there a role for soil sampling? Yes, for general monitoring of the overall effectiveness of the soil protocol, but not for granting of individual offset credits. USDA should do systematic soil sampling to monitor the progress of the soil offset protocol and to periodically adjust the generalized crediting rate. Over time, the more data points that exist, the more localized the differentiation of the crediting rate that can be established with statistical confidence.

Permanence versus Duration

While biological processes are not permanent, they do have substantial duration and the lack of permanence should not be used as a reason to restrict or limit the use of biological sequestration as carbon offsets. Attached in our written testimony is a briefing document about how an implicit "permanence reserve" can be incorporated into sequestration offset design which allows

the registered credits from sequestration activities to have the characteristics of permanence and be fully fungible with other offsets.

Credit Integrity and Offset Reversals

In order to maintain market integrity, it is essential that registered, serially-numbered offsets not be subject to de-listing due to a reversal event of a specific project. A buyer of a registered offset credit must be assured that the credit, once registered, represents a viable compliance unit and will not be disqualified after registered or purchased.

Offset providers should be fully accountable for reversals during the period of active crediting. We support the concept of a compliance reserve for biological sequestration offsets in which a specified percentage of the registered credits are held in a not-available for trading compliance reserve until the term of the crediting period is completed. The credits held in this reserve should be used to cover any reversals that may occur under a sequestration project. However, a reversal should not result in a de-listing of a registered credit. A reversal during the active crediting period should result in a requirement that the reserve account be reduced by the amount of any reversal. Once the active crediting period is completed, reserve credits should be released as available for sale. Any reversal that might occur after the active crediting period would be covered by the implicit permanence reserve that was deducted at the time of credit quantification. This assures that all registered credits have met the permanence criteria.

Market Regulatory Framework

Harm Bureau policy states, "The integrity of all U.S. commodity futures and options exchanges as a pricing mechanism must be maintained by the members of the exchanges and their overseeing governing bodies. Commodity futures and options trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. Other commodities should be included where need exists and research shows futures and options trading would be beneficial. We urge that regulatory laws be strictly enforced. We support the use of off-exchange agricultural trade option contracts in commodity marketing, which would include complete risk disclosure, vendor integrity and the opportunity for cash settlement of the option."

As is being demonstrated by the early action programs, carbon can and is becoming a commodity that can and will be traded just as other commodities. The experience of the Chicago Climate Exchange is proving that markets for carbon can and do work. (See Figures 2 & 3) While the CCX market is currently operating as an Exempt Commercial Market under the Commodity Exchange Act, its regulatory status may change as the CFTC is now assessing whether CCX performs a "Significant Price Discovery Function".¹ Based on the requirements of the regulated carbon market, contracts and services are being developed to supply projects and products that

¹ CCX also operates the Chicago Climate Futures exchange, a CFTC-regulated Designated Contract Market that is the only active marketplace for futures and options contracts on USEPA SO₂ and NO_x allowances, as well as carbon dioxide emission allowances in Regional Greenhouse Gas Initiative.

meet market requirements. However, the actual registry and retirement of allowances and offsets should be done on regulated, open, transparent markets with specified standards for price reporting that would include date of transaction, vintage, quantity and pricing information.

CFTC Regulation

The CFTC should continue in its role as the regulator of derivatives, futures and options contracts associated with carbon trading. Farm Bureau opposes efforts to combine CFTC and the Securities Exchange Commission and supports regulation of the commodity futures business by CFTC. Derivatives, futures and options on carbon contracts are not fundamentally different than other derivatives, futures or options contracts. The oversight and regulation provided by the CFTC is adequate for these markets. However, we urge CFTC to be diligent in its oversight of futures exchanges and floor traders to ensure that integrity of these markets is maintained and to curb practices that could result in manipulation or artificial price swings.

The CFTC should establish speculative position limits for carbon futures and option market with appropriate exemptions for bona fide hedgers and end-users of carbon credits. Investment and index funds should be subject to speculative position limits. To minimize the potential market distortions and/or manipulations, carbon market derivatives should be required to clear on regulated, public exchanges with full price reporting.

Similar to corn, soybeans and other agricultural commodities, the cash market transactions between farmers, ranchers, forest landowners and project developers and aggregators should be exempt from direct regulation by the CFTC. There is sufficient state contract and business law to govern these transactions.

Capital and Margin Requirements

Leverage is an issue in the financial markets. One of the major contributors to defaults of credit default swaps and mortgage-backed securities was leverage, particularly in the derivatives of these products. High degrees of leverage set the stage for small swings in market conditions to cause financial stress. It is important to note that throughout the stress in the financial markets of the past year, no defaults occurred on the regulated futures exchanges. The market structure and discipline that is imposed on these markets helped them perform while the over-the-counter market was at times in a state of disarray. Farm Bureau policy supports the governing body of the commodity exchanges to continue to establish predetermined, publicized limits for margins at various market price levels for each commodity. We believe the leverage levels of derivatives traded by major market participants should be examined and brought under greater regulatory scrutiny by the appropriate regulatory agency. Margin and capital requirements that create a strong incentive for dealers and users of derivatives to trade them on regulated exchanges or regulated electronic platforms should be developed.

USDA Administration of Offsets

As part of the regulatory structure for carbon, USDA should be charged with unique responsibilities regarding offsets. USDA should develop a set of agency-approved offset

standards and protocols for biological sequestration from agriculture and forestry and methane destruction that would be used the mandatory carbon market and could be used by voluntary carbon markets. USDA should provide the administrative support and oversight of offset standards development, review, and update and should be actively engaged in coordinating the linkage of U.S. domestic offsets with international offset markets. The agency oversees standards for grains, livestock and other agricultural markets and should be the agency in charge of setting standards for carbon market offsets.

Thank you for the opportunity to provide input and information to the Committee.

Included as part of our written comments is a summary of Farm Bureau policy regarding carbon regulation, carbon markets and commodity futures and options markets.

How Chicago Climate Exchange Contracts Create Carbon Offsets that Represent “Permanent Reductions”

- 1) At the Chicago Climate Exchange (CCX), contracts for offset credits cover a 5-year period for cropping practices and a 15-year period for forestry practices.
- 2) Under a CCX contract, an offset provider agrees to initiate and maintain a set of practice(s) that, for the contract period, reduces CO₂ equivalent emissions by a specified amount. CCX utilized a scientific panel to inform the CCX offset committee regarding the appropriate rate of carbon sequestration that would occur under various practices. The actual crediting rates utilized by CCX represent a 20% reduction from the “scientific” rate recommended by the scientific panel.
- 3) Once offset practices have been implemented and verified, the first year’s tradable offset credits are issued to the provider. Additional offset credits are issued annually for each year of the contract; under a five-year contract, a producer would receive five years of offset credits. The credits are considered to be “permanent” reductions in CO₂ equivalent emissions.² (How this works, in practice, is explained below.)
- 4) At the end of the contract period, the producer is under no further obligation to maintain the offset practices. Using a crop example, the producer has provided five years of offset services and, in return, has received five years of tradable offset credits. How then, can five years of offset practices and offset credits be considered permanent reductions?
- 5) The mechanism which causes offsets to be considered permanent reductions is that producers receive only 80% of the CO₂ equivalent reductions that the CCX calculates they have actually made. This 20% discount, in effect, provides a “Permanence Reserve” of actual offsets that have occurred but have not been credited. As long as the amount of any reduction leakage caused by producers who discontinue offset practices after their contracts expire is, in aggregate, less than the offsets in the Permanence Reserve, then, in practice, the reductions can be considered to be permanent. In other words, CCX considers that the offset reductions are permanent for the system but not for each individual contract.
- 6) The Permanence Reserve only applies to “reversals” after the end of the contract period. All offset providers are responsible for meeting the contract provisions on which their soil sequestration credits are based during their contract period. Any actions taken by an offset provider that results in a reversal while “under contract” would require a complete recovery or replacement by the offset provider of the “reversed” offsets covered by the contract. Therefore, there is full accountability by individual offset providers during the period of

² Consider a five-year CCX contract whereby a producer agrees to use no-till practices to grow his corn and soybeans beginning with the 2009 crop year. If the “actual” CO₂ equivalent reduction as determined by the CCX is one metric ton per acre per year, the producer receives an offset credit of 0.8 tons for 2009, an offset credit of 0.8 tons for 2010, an offset credit of 0.8 tons for 2011, an offset credit of 0.8 tons for 2012, and an offset credit of 0.8 tons for 2013. Over the five-year contract period, the “actual” reduction is 5 tons but the credited reduction is 4 tons.

active contracting and the systemic accountability by the Permanence Reserve for reversals that may occur after the contract period.

- 7) Note that the Permanence Reserve operates, in a sense, through a sort of “invisible hand.” Individual contracts are not tracked for permanence and offset credits are not deposited into or withdrawn from the reserve. A key question is how big does the invisible hand need to be? We believe that USDA could conduct periodic surveys to inform the system about how large of a reserve is really needed. Based on survey results of actual reversals, the discount rate could be adjusted every 5 years to reflect the true risk of post-contract reversals. In addition, incentives for contract renewal, which maintains full accountability for reversals, could be incorporated to further reduce potential post-contract reversals.
- 8) CCX believes that the 20% discount reserve is more than sufficient to offset permanently the leakage that occurs if some producers discontinue offset practices after their contracts expire. First, producers can renew a contract, continue the practices, and continue to receive credits.³ Second, if some producers stopped contracted practices after the end of the contract, the most likely practices that would replace them likely would be carbon neutral⁴—i.e., not sequestering additional carbon but not, on net, emitting additional carbon, either. Third, practices such as no-till have a propensity for continuance for many producers once they have gotten over the initial hurdles of adoption and the producer becomes comfortable with all aspects of the practice. Continuation of the practice is further enhanced because of the capital commitments already made in implementing the practice, and because of potential future savings associated with the reduction in energy use from fewer trips across fields and reduced labor requirements associated with continuing the practice.
- 9) The CCX originally used a 30% discount from calculated actual reductions in determining the number of offset credits to issue but eventually concluded that 30% was too high. Some analysts believe that the discount percentage needed for the Permanence Reserve to work is in the 2% to 3% range. Annual USDA surveys of tillage practices to determine the levels of reversal activity on previously no-tilled lands would provide a good indicator of whether the Permanence Reserve provided by a 20% discount factor is too high or too low.
- 10) Approaching the permanence issue indirectly in a systemic way—rather than requiring permanence for individual contracts—is needed because of the structure of U.S. farming. Much land is rented out and farms are sold. Producers of particular tracts change over time. Dave Miller of the Iowa Farm Bureau, an expert on the CCX, notes that five-year contracts are about as far as contracts can be stretched and still get participation by farmers. “We need to trust the system to, on average, establish permanence for offsets. Without some approach like the CCX discounted credits and the ‘Permanence Reserve’ they create, a broader offset system for agriculture will never get off the ground.”

³ While there is a saturation point where no additional carbon can be sequestered so additional contracts would not work, the two following points indicate reasons why already sequestered carbon will not necessarily be released in large amounts—which is the condition that must be met for the CCX offset structure to be considered as providing permanent offsets.

⁴ Research by Drs. Alan Franzluebber, Jerry Hatfield, Charles Rice, etc.

- 11) All soil sequestration credits "share the burden" of potential loss of permanence. This method actively recognizes that there is a positive probability that some sequestration reversal activity could take place after the end date of the contract and that some portion of the sequestered carbon could be released to the atmosphere. However, it also recognizes that the exact timing, intensity and location of that reversal or carbon releasing activity is not known at the time of crediting for any soil sequestration activity, therefore all soil sequestration credits share the risk of a post-contract reversal by having a portion of their credits from current sequestration activities reduced by committing some pre-determined fraction of the actual sequestration rate to the implicit Permanence Reserve, thus reducing the actual amount of credits to that which now have the characteristics of "permanence". This approach removes the significant administrative burden of post-contract tracking of offsets and allows credited offsets to be fully fungible within the compliance regime. Post contract monitoring can be achieved by the survey methods previously listed and ongoing adjustments to the program and crediting rates, as appropriate.
- 12) Across a large landscape (such as production agriculture) the law of large numbers applies and the laws of probability apply. If all of the offsets from that class of offsets share the probability of loss of permanence and have that probability of loss quantified into the crediting rate, then the resulting "credited" offsets will only reflect the portion of offsets that are permanent.

Figure 1. U.S. Farmer and Landowner Participation in CCX Offset Programs
9,008 producers enrolled, 16,632,284 acres, 37 States

| State | Number of Producers | Acres Enrolled | State | Number of Producers | Acres Enrolled |
|-------|---------------------|----------------|-------|---------------------|----------------|
| AL | 133 | 600,122 | MT | 484 | 1,701,004 |
| AR | 56 | 61,886 | NC | 10 | 4,000 |
| CO | 260 | 631,058 | ND | 1,381 | 1,804,845 |
| FL | 35 | 90,000 | NE | 1,553 | 3,754,961 |
| GA | 22 | 90,532 | NJ | 1 | 19 |
| IA | 671 | 386,534 | NM | 31 | 731,169 |
| ID | 8 | 40,846 | NY | 2 | 581 |
| IL | 942 | 200,443 | OH | 116 | 58,723 |
| IN | 133 | 94,947 | OK | 12 | 23,833 |
| KS | 402 | 505,790 | OR | 7 | 28,003 |
| KY | 133 | 75,580 | PA | 13 | 5,982 |
| LA | 42 | 32,858 | SC | 17 | 80,245 |
| MD | 10 | 5,155 | SD | 956 | 3,145,518 |
| MI | 395 | 186,016 | TN | 14 | 11,454 |
| MN | 247 | 70,899 | TX | 305 | 594,006 |
| MO | 92 | 45,663 | VA | 40 | 10,211 |
| MS | 182 | 50,337 | WA | 7 | 39,957 |
| MT | 484 | 1,701,004 | WI | 221 | 69,686 |
| | | | WY | 75 | 1,399,422 |

Figure 2. Emission Reductions and Project-based Offsets in CCX Years 2003 through 2007* (metric tons CO₂) – As of 02/20/2009 since a portion of new member emission reductions are currently undergoing verification.

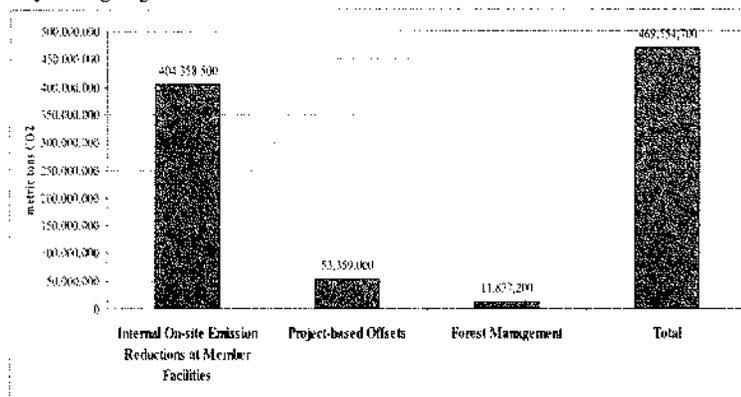


Figure 3. Chicago Climate Exchange Carbon Financial Instrument Spot and Derivatives volume 2004-2008

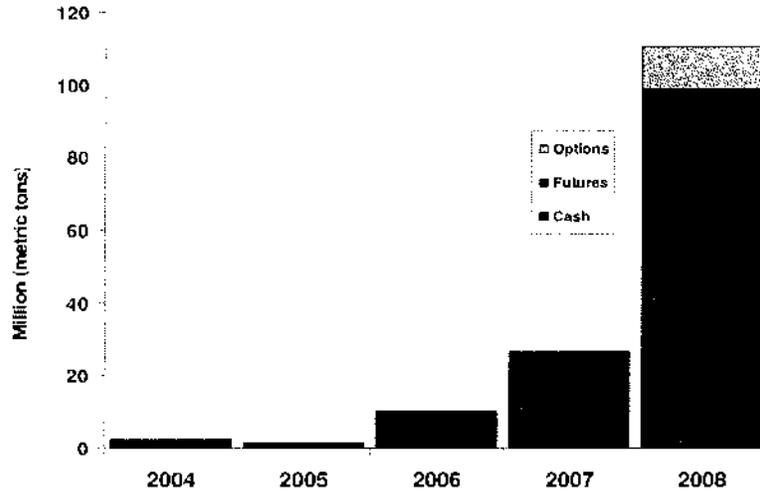
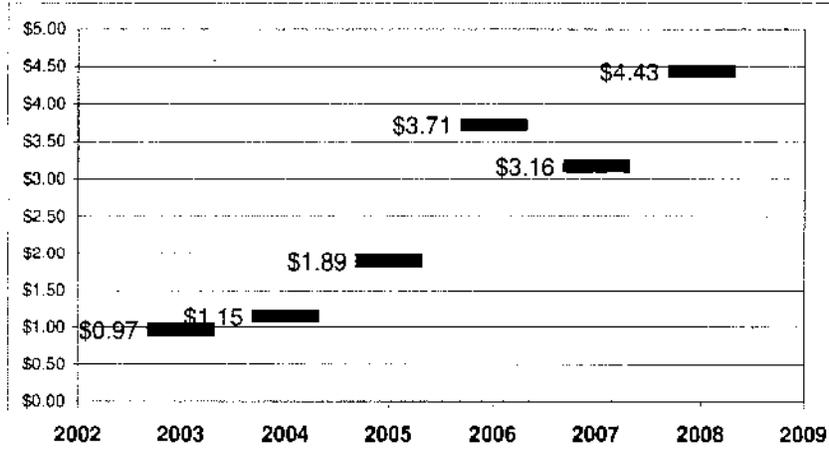


Figure 4. Annual Average* Price for CCX Carbon Financial Instruments 2003-2008



American Farm Bureau Federation policy on Carbon and Environmental Credit Incentives

We oppose the imposition of carbon emission related taxes or fees on horsepower of vehicles and equipment used for agricultural production.

We support research that identifies the advantages and disadvantages of carbon credits as it relates to carbon sequestration;

We oppose:

- (1) Mandatory air quality standards for ozone and particulate matter on farmers and agricultural businesses;
- (2) Air permits for agricultural operations that are not science based; and
- (3) Any efforts by the EPA to implement permitting fees and/or protocol or take regulatory action regarding greenhouse gas emissions for production agriculture.

Environmental Credit Incentives

Market-based incentives, such as pollutant credit trading, are preferable to government mandates.

We support:

- (1) The development of a practical voluntary market-based carbon credit trading system. To encourage this new market, we also support a USDA pilot carbon credit trading project to develop trading criteria, standards and guidelines;
- (2) Farmers being compensated for planting crops or farming practices that keep carbon in the soil;
- (3) Seeking alternative energy sources, which will minimize atmospheric pollution;
- (4) Providing incentives to industries seeking to become more energy efficient or reduce emissions of identifiable atmospheric pollution and the means of preventing it;
- (5) Providing incentives to individuals seeking to reforest fragile lands that are currently in agricultural production;
- (6) Emission offsets that sequester carbon through agricultural practices should be fully recognized in any cap and trade system and should not be limited to a percentage of total offsets;
- (7) Participation in climate discussions to enhance and maximize agriculture's ability to capture economic benefits from an emerging carbon market; and
- (8) Market-based solutions, rather than federal or state emission limits, being used to achieve a reduction in greenhouse gas (GHG) emissions from mobile sources.

We oppose:

- (1) Mandatory restrictions to achieve reduced agricultural greenhouse gas emissions;
- (2) Mandates relating to GHG policies, that would adversely impact agriculture;
- (3) Any attempt to regulate methane emissions from ruminant animals under the Clean Air Act or any other legislative vehicle;
- (4) Emission control rules for farming practices, farm equipment, cotton gins, grain handling facilities, etc., and urge EPA to re-evaluate the imposition of standards on farm and ranch equipment and other non-highway use machinery;
- (5) Unilateral mandatory state or federal GHG emission reduction requirements; and
- (6) Including the carbon impacts resulting from indirect land use changes in other countries in the carbon life cycle analysis of biofuels.

American Farm Bureau Federation Policy on Commodity Futures and Options

The integrity of all U.S. commodity futures and options exchanges as a pricing mechanism must be maintained by the members of the exchanges and their overseeing governing bodies. Commodity futures and options trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. Other commodities should be included where need exists and research shows futures and options trading would be beneficial. We urge that regulatory laws be strictly enforced. We support the use of off-exchange agricultural trade option contracts in commodity marketing, which would include complete risk disclosure, vendor integrity and the opportunity for cash settlement of the option. We should provide educational programs for producers to learn about this risk management tool and work with commodity buyers to offer agricultural trade option contracts.

We will:

- (1) Aggressively work to maintain agricultural representation on Commodity Futures Trading Commission (CFTC);
- (2) Oppose efforts by CFTC to regulate cash grain;
- (3) Encourage CFTC to require additional delivery points and assure an adequate delivery system;
- (4) Continue to work with state Farm Bureaus and their affiliated marketing agencies to encourage the expansion of forward pricing services based on futures and options and to strengthen current programs;
- (5) Encourage worldwide electronic trading at U.S. commodity exchanges;
- (6) Support expanded use of mini-futures contracts on all commodity exchanges;
- (7) Support changes in current futures contracts if research shows that they will result in maintaining or increasing liquidity of the market;
- (8) Oppose efforts to combine CFTC and the Securities Exchange Commission and support regulation of the commodity futures business by CFTC;
- (9) Urge CFTC to increase oversight of futures exchanges and floor traders to ensure that integrity of these markets is maintained and to curb practices that result in manipulation or artificial price swings;
- (10) Review price-setting mechanisms and make recommendations for the most effective price discovery systems for identity-preserved grains;
- (11) Urge the governing body of the commodity exchanges to continue to establish predetermined, publicized limits for margins at various market price levels for each commodity;
- (12) Oppose efforts by the commodity exchanges to charge a fee for delayed market quotes;
- (13) Conduct a review and actively participate in the reauthorization of the Commodities Exchange Act. That review will seek to minimize price manipulation and ensure the markets are effective as a price discovery mechanism given the increasing levels of contract production;
- (14) Encourage commodity exchanges to have an active and viable agriculture advisory committee; and
- (15) Support regular and thorough review of the CFTC and commodity markets.

We encourage the use of marketing tools or other marketing alternatives. We support hedge-to-arrive contracts being honored when used as a marketing tool that ensures delivery of the

commodity on the contract and has a set delivery date. Those entering into these agreement or contracts should be held liable for their own actions.



NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS
DUKE UNIVERSITY

TESTIMONY OF TIMOTHY H. PROFETA

DIRECTOR

NICHOLAS INSTITUTE FOR ENVIRONMENTAL POLICY SOLUTIONS

DUKE UNIVERSITY

before the

U.S. SENATE COMMITTEE ON

AGRICULTURE, NUTRITION AND FORESTRY

September 9, 2009

Chairman Harkin, Senator Chambliss, and members of the committee, thank you for the opportunity to testify before the Committee today. It is an honor to be here.

Four years ago, I left Washington to found the Nicholas Institute for Environmental Policy Solutions at Duke University. The Institute is intended to be a two-way bridge between the knowledge and convening power of Duke and decision-makers such as yourselves. The Institute has focused its resources on the key environmental challenges facing our planet, and no topic has demanded greater attention than global climate change.

One area in which the Institute has recently focused is designing the financial market that would be created by a cap-and-trade system for greenhouse gases. It is clear that the success of this policy approach hinges, substantively and politically, on whether the market will operate in a way that is fair, efficient and responsive to the lessons learned from the current financial crisis. The Institute staff has worked with our Visiting Fellow Jon Anda to launch our Carbon Market Initiative, engaging with a number of faculty from Duke University's Fuqua School of Business and Law School to assess the key elements of a successful carbon market – from financial market design, to accounting, to auction design. Three papers are due to be published in October, led by Professors Vish Viswanathan, Leslie Marx and Katherine Schipper, that will more deeply investigate all of those topics.

The Benefits of a Market-Based Climate Policy

As I noted, this testimony is focused on the issues and concerns regarding the design of the greenhouse gas market. Given the financial market failures in recent years, it is understandable that a market approach should not be viewed as a foregone conclusion. However, I would submit that, given the Nicholas Institute's evaluation of the numerous policy options proposed to

address climate change, I believe the market approach remains an effective means to achieve the environmental goals of greenhouse gas emission reductions at the lowest cost.

Cost, in the end, is the determining factor. No sector of the economy is more attuned to these issues than the agricultural producers who are the constituents of this committee. As an aside, let me note that the Nicholas Institute this week released a report co-authored by several leading agricultural economists assessing the impact of a carbon market on farm incomes. The study found that net flow of GHG revenue and indirect commodity market revenues for farmers far outweigh increased operating costs. The study also forecast some losses in economic welfare to consumers and agricultural processors. However, benefits to crop and livestock producers far outweigh these economic losses, signaling gains to the sector as a whole. If done the right way, agriculture can be made a winner in climate legislation.

But no matter what the models show, no one would dispute that we should adopt the policy that achieves our goals at the lowest possible cost. History demonstrates that the market is the best means to accomplish this objective. In the most famous example, Congress mandated in the 1990 Clean Air Act that utilities engage in what was then called "emissions trading" to reduce sulfur dioxide pollution – a major contributor to acid rain. The 1990 Clean Air Act amendments, which launched the program, are a resounding success—achieving the environmental goals at 20 to 30 percent of the predicted cost.

Market-based systems to address environmental concerns allow both the federal government and private enterprise to take advantage of their respective strengths. The U.S. government is in the best position to set and enforce a "cap", or limit, on national GHG emissions. Capped entities determine for themselves the least-cost manner of complying with the emissions limits.

Under a cap-and-trade program, a GHG "allowance" is created for each ton of capped emissions. The allowances are fungible and can be traded among market participants. At the end of each compliance period, regulated firms surrender allowances to the government equivalent to their emissions. The program gives firms flexibility, either to reduce their own emissions or to buy allowances from another firm. This process minimizes the overall economic cost of the program, as it provides an incentive for firms with the lowest marginal cost of abatement to make the cheapest reductions first. Cap-and-trade systems are at the heart of the major legislative proposals to address climate change, including the American Clean Energy and Security Act passed by the U.S. House of Representatives earlier this year and the Climate Security Act that was before the Senate in June of 2008.

Without a market mechanism, the government must have perfect foresight of the costs of emission reductions and the circumstances that will affect those costs (such as when technologies will be available) in order to deploy resources most efficiently. Providing covered entities with flexibility in how they trade allowances among themselves may be especially important in this circumstance, as long-term compliance with the declining cap will depend on the emergence of new technologies.

Lessons Learned from Recent Market Failures

Much of the market's cost-reducing benefits, however, could be weakened if the market does not operate transparently and efficiently, thereby creating a sizeable gap between the price of greenhouse gas abatement and the price in the market. Americans know all too well that such imperfect markets occur, as the debate on climate change legislation takes place in the shadow of glaring examples of market failures over the past year and a half. These failures, however, can also provide important lessons that Congress can apply to the creation of a carbon market.

1. **Petroleum price spikes** – The spikes in the petroleum markets during the summer of 2008 highlight the importance of market transparency and adequate regulatory jurisdiction. No federal agency has comprehensive authority to regulate offshore petroleum markets and there was insufficient information to monitor potentially manipulative activity adequately. As a result, government officials and the general public were unable to determine the degree to which the price spikes were caused by excessive speculation, market manipulation, or normal market reactions to supply and demand. Recent regulatory changes give regulators this power, an important aspect of a successful regulatory process.
2. **Credit Default Swaps** – The economic crisis caused by failures of credit default swaps highlight the importance of a system for settling counterparty risk. In the CDS market, the settlement practice was inadequate, and the regulator was not aware of the vulnerable positions taken by major market players. The experience has underlined the need for transparency and adequate risk management. There is widespread acknowledgment that the CDS market would have benefited from (a) more government oversight to ensure the underlying value and integrity of the financial instruments and (b) more information to allow market participants to evaluate the risk of the parties with whom they were contracting.
3. **The Madoff Affair** – The Ponzi scheme orchestrated by Bernie Madoff highlights a separate issue—the importance of a vigilant regulator with adequate oversight authority and resources. In the Madoff situation, as the recent SEC inspector general's report indicates, the data needed to unearth the scheme were readily available; the cops were simply not walking the beat.

The lessons learned from these recent experiences are really quite clear, and if they are applied to the carbon market, should avoid repeats of the prior failures. In fact, the mechanisms to address these concerns already exist, and are included in many of the broader market reform proposals currently under consideration, including increased oversight, mandatory clearing of standardized products, real-time pricing and volume transparency, and expanded agency jurisdiction to cover the full scope of activity in a marketplace. These reforms, if passed by Congress, may apply across U.S. financial markets, including a new carbon market.

Unique Aspects of the U.S. Carbon Market

Many will claim that the carbon market should be treated just like any other commodity market. But it would not be like any other market – it will be somewhat unique. There are three distinguishing aspects of the market.

First, unlike markets in physical commodities, the entire carbon market system is created by the government to achieve a societal goal. Demand for the product, and the product itself, is created by government action, and thus the government has a special duty to ensure that its market operates effectively. Confidence in the product is also essential; in this way, the government's role in providing an accurate and transparent registry of emissions and in creating the protocols to ensure that offsets are real and verified are essential to keeping confidence in the market.

Second, entities covered by the legislation will have no choice but to participate in the market, and it is a market with an ever-reducing supply. For example, if the American Clean Energy and Security Act became the law of the land, a pool of 5.5 billion allowances in 2016 would decline to 5.1 billion in 2020 and 3.5 billion in 2030. Unlike traditional commodity markets, options for increasing supply in the event of allowance shortages will be limited to the amount of credits allowed from offset projects that operate outside of the covered sectors.

Third, the carbon market is likely to be driven heavily by derivative instruments (i.e., futures and options), underscoring the need to design an appropriate regulatory structure from the outset. Legislation will likely result in the existence of two major markets: (1) a cash market that will trade allowances from the current year; and (2) a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances.

Because of the design of climate legislation, the derivatives market will likely dominate. In particular, climate legislation will likely create a long-term obligation for regulated entities and those entities will need access to financial instruments to hedge their exposure—a necessary element to securing investment for new, low emitting energy technologies. The American Clean Energy and Security Act, for example, would distribute 132 billion allowances from 2012 through 2050. Yet, less than 5 million allowances will be issued in the first year of the program. This small initial “float” of allowances will likely drive demand for derivatives that offer future protection against price changes. Looked at another way, we are asking emitters to take on 38 years of abatement with potentially as little as 1 year of allowances available to manage risk.

From that perspective, it is entirely appropriate that we are here today, as the Commodities Futures Trading Commission is the natural entity to regulate the derivatives market expected to arise under these circumstances. Effective regulation of these markets is critical to ensuring a stable market that provides covered entities with the financial products necessary to meet their compliance obligations in an efficient manner.

At bottom, we must develop this market *de novo*. Financial markets typically evolve over time as they grow, and regulatory changes often follow the development of new financial products or respond to failures in the market system. Because Congress would create a new carbon market via legislation, lawmakers have the opportunity to design a transparent, efficient market at the

outset that builds on the best practices for market regulation and lessons learned from recent market failures.

Four Principles for the Carbon Market

I would like to leave you with four principles for an effective carbon market based on the lessons of the past decade: (1) real-time transparency; (2) adequate risk management and settlement; (3) a vigilant and well-funded regulator; and (4) transparent data and strong quality controls on the allowances traded.

1. Real-Time Transparency

Electronic markets for stocks and bonds have demonstrated that real-time transparency has made markets more efficient. Electronic markets also facilitate real-time market oversight – making it better, faster, and cheaper. Real-time access to information about market activity is the cornerstone to managing risk, reducing market volatility, and empowering market participants and watchdog organizations to monitor the market for manipulation, excessive speculation, and other illegal activity. Accurate, real-time information about prices and trade volume allows market participants to make more accurate bids and offers. This, in turn, helps to ensure that allowance prices more accurately reflect the marginal cost of abating emissions.

Transparency also can help maintain public confidence in the fairness and stability of the market—an element that may be essential to the long-term success of the cap-and-trade program’s ability to reduce emissions in a cost effective manner. Real-time market information allows the public to monitor the effectiveness of the regulator as well as the behavior of market participants. Market data collected from multiple sources could also help assure public investors that their assessments of price, market direction, and counter-party risk are based on accurate data. In addition, disclosure requirements for publicly-held companies and financial institutions allow investors to verify the accuracy of financial reports.

In general, publicly-available information should include:

- The instruments that are trading;
- Prices;
- The volume of trading activity;
- Where trading is taking place
- The entities that are trading and the positions they hold; and
- The positions held by market participants.

To the extent that carbon instruments are traded on registered exchanges, the exchange member’s activity will be “printed” on the exchange as the trade occurs. This would apply to allowances, futures, options, and possibly swaps. If OTC transactions take place in the carbon market, the legislation will need to ensure that the regulator, market participants, and the general public have sufficient data to oversee and evaluate trading activity.

Congress will need to balance the public's access to timely market information with the legitimate concern that covered entities may need to protect confidential business information. It is important to note that the default real-time transparency as to "who" is trading is limited to the registered exchange member. In some cases this may be an emitter, but in many cases it will be an intermediary. Emitters, just like large mutual funds in the equity markets, could report their positions at a later date so that their activity cannot be "front-run" by others. Emitter reporting could be monthly or even quarterly along with their financials.

In addition to the information made available to the general public, regulators should have access to the full range of market activity in real-time in order to prevent and punish market abuses, including fraud and manipulation. The more detailed information an oversight body receives concerning trade prices, volume, positions, and trends, the better its capacity to detect trading irregularities and inconsistencies. With each of these elements in place, regulators can respond quickly to unexplained spikes in market price or trade volume to abate excessive speculation and ensure that prices reflect supply and demand.

2. Adequate Risk Management and Settlement

Carbon market participants also need to know that allowances purchased on the spot, forward and futures markets, which are held to maturity, will be delivered. The collapse of the mortgage-backed securities and credit default swaps markets in the fall of 2008 highlights the importance of managing the levels of risk that market participants may undertake.

In regulated financial markets, counterparty risk is generally managed by "clearing" transactions. Clearing consists of the confirmation, settlement, and delivery of transactions. Clearing houses serve as a central counterparty in a transaction in order to protect opposing parties from a default by the other. Clearing houses also compute the adjusted value of open positions on futures contracts (how much is owed or collectible) based on changes in contract prices – and use this information to adjust margin to ensure integrity on the marketplace. In addition, the clearing organization may verify the transactions between parties to discover and resolve any discrepancies quickly.

In the carbon market, a capped entity cannot run the risk that a contract to purchase allowances will not be fulfilled. This is the element of a compliance market that differs from a financial market. One can imagine financial remedies for non-performance of a carbon allowance contract. However, the capped entity that has not had its purchase filled with a physical delivery cannot submit to the EPA a financial settlement—it must submit allowances. Monitoring of the spot, futures and forward markets to assure that market participants are able to make delivery on their contractual agreements will be an important part of the regulators role in the carbon markets.

As much trading should occur on exchanges, or at least be cleared centrally, as is feasible. The system that you are building for this market really has three goals: (1) price discovery, (2) transparency, and (3) risk management through clearing. An exchange requirement would achieve all three goals; a requirement to print and clear all trades, even those occurring over the counter, will achieve the latter two. And in fact, as long as some significant volume occurs

across the exchanges, there will be discovery of prices that can be used to inform the OTC transactions as well.

Many will contend that clearing of long-term structural contracts will be difficult, as such transactions are unique and not liquid, and that parties will be required to post the collateral, or margin, necessary to participate in the market. These are nontrivial issues, and pose a choice between mitigating systemic risk and creating the additional cost of posting margin for entities. It will be your role to evaluate the tradeoff between these priorities.

In the case that Congress provides any exceptions to cleared or exchange-traded transactions, transparency for the counterparties and the regulator is even more essential so that the counterparty risk can be effectively evaluated.¹ Such exceptions should only occur if regulators know the extent of the obligations of the various counterparties in the carbon allowance and allowance derivative markets so as to ensure that such OTC markets remain properly regulated.

3. Vigilant and Well-Funded Regulator

Access to market data should be coupled with sufficient resources to process and analyze the information, broad jurisdiction that allows the regulator to oversee any trading that involves allowance-based financial instruments, and appropriate enforcement to address market abuses when and where they may occur. If Congress will ask the CFTC to take on the oversight of this new market with the degree of detail that is suggested here or in the current proposal from Senators Feinstein and Snowe, then more resources will be required to build the team of regulators needed. Some would fund this through a fee applied to trades. I would suggest that another alternative exists in tapping the value from auctioned allowances. Either way, the legislation has the means to create the funds needed.

With respect to the regulator's vigilance, it is a challenge that this Committee can uniquely answer. Tight Congressional oversight will help ensure that the "cops remain on the beat." And some forethought might further benefit that oversight, as the Committee might ask for data about the market to be provided regularly so that it too can monitor the market.

4. Transparent data and strong quality controls

Finally, the government must ensure that the information regarding the allowances traded in the market is transparent, predictable and reliable. Information, in the end, is what enables you to turn emissions into a tradable item. It gives the market apples-to-apples confidence in the products, particularly since greenhouse gas emissions are not as tangible a commodity as oil or pork bellies.

¹ What exceptions should there be for non-standard instruments to be transacted OTC? One suggestion developed by Professor Vish Viswanathan at Fuqua School of Business and that will be published in his October paper is to use the post-trade reporting of non-standard instruments to determine when volume is sufficient to require the contract to be "printed and cleared" on an exchange. For example, if there was a large volume of swaps for, say, carbon versus Libor, then such contracts could be required to move to listed trading.

First, the government must regularly and predictably produce information about the nation's emissions to allow for the market to evaluate demand. A good example of an effective program in this regard is the U.S. Acid Rain cap-and-trade program administered by the EPA. That program focuses the majority of its enforcement efforts on the accurate tracking of emissions and allowances. EPA handles vast amounts of information; it processes information for compliance purposes and makes emission and allowance data accessible to facilitate an efficient allowance market which builds public credibility in the emissions trading program. The key is that the ARP relies on a common measurement metric through rigorous continuous emissions monitoring systems (CEMS) with quarterly reporting of hourly emissions.

An example of how the poor provision of government data temporarily undermined a market can be found in the European Union. In the E.U. Emissions Trading System, most emissions were not measured directly; they were determined by calculation based on fuel consumption, specified emission factors and the thermal efficiencies for combustion units and on output and other chemical and engineering estimates for process emissions. During the 3 year experimental phase in the EU ETS (2005-2007) a significant price decline occurred in April 2006 following the reporting of 2005 emissions data by several member states in amounts that were significantly less than expected.

The government also must provide the market with adequate assurances that the products traded in the carbon market are what they claim to be. With regard to the emissions allowances, this is simple and straightforward. The government will create, serialize and track the government-issued right to emit.

With regard to offset credits, however, the government's role is to provide adequate protocols and procedures to ensure the market that any carbon offset project is real and verified. In particular, for offsets markets to be successful and to contribute to emission mitigation goals, there must be confidence that offset reductions do in fact occur, that they can be properly quantified, that they are additional to what would have occurred without the project, and that any re-emission later (reversal) or induced uncontrolled emissions in other locations (leakage) are properly accounted. In doing so, the government must balance the need to provide quality assurance with the need to keep the costs of verification and monitoring low enough to attract investment in the projects.

Fortunately, I believe such a balance can be struck. In our work at the Nicholas Institute, we have engaged with producer groups, market participants, environmental advocates, and emitters to design policy that can provide environmentally valuable offsets at lower transaction costs. These efforts, first published in our report *Designing Offsets Policy for the U.S.*, continue as we strive to find the correct balance.

I also now serve on the board of the Climate Action Reserve, a national organization focused on providing regulatory-quality standardized protocols for the development, quantification and verification of greenhouse gas emissions reduction projects in North America: issuing carbon offset credits known as Climate Reserve Tonnes (CRT) generated from such projects; and tracking the transaction of credits over time in a transparent, publicly-accessible system. For the project types already approved by the Climate Action Reserve, I believe that the protocols have

struck this balance, for at least some project types, as evidenced by the strong investor interest in offsets projects using their program.

One final note – Accounting

While time does not permit a fulsome discussion of this issue, I would like to draw your attention to a short line in the U.S. Climate Action Partnership blueprint highlighting the need for “rational accounting” If a utility needs a futures contract as a bridge to a new low-carbon power plant – and their intention is to take delivery of the allowance at expiration to submit for compliance – should that utility have to mark the contract to market each quarter? Such a requirement should not be imposed lightly, since doing so would only encourage OTC hedging, or less risk management overall.

Conclusion

The market is very powerful tool, by which environmental objectives may be achieved at historically low costs. But the market also can fail, particularly if it does not have adequate provisions to ensure that transactions are fair and transparent. As I have testified, I believe the mechanisms exist to avoid such a failure.

Concerns about market abuses have nonetheless led some to conclude that now is not the time to create a new market. Let me posit that the exact opposite is true. If you choose to create a market, now is the best time to create a transparent, effective market that prevents excessive speculation and manipulation while allowing individual business leaders the flexibility to decide how to comply. The lessons from past market failures are fresh in our minds, and the public is attuned to the needs. If it wants to do so, Congress has all the tools it needs to create a well-functioning marketplace.

REFERENCES

- Testimony of Jon A. Anda before the Subcommittee on Energy and the Environment, House Energy and Commerce Committee, April 24, 2009, available at http://energycommerce.house.gov/Press_111/20090424/testimony_anda.pdf
- Justin Baker, et al., *The Effects of Low-Carbon Policies on Net Farm Income*, Nicholas Institute Paper NI WP 09-04 (2009)
- Denny A. Ellerman and Paul L. Joskow, "The European Union's Emissions Trading System in Perspective", Pew Center on Global Climate Change (2008).
- Richard F. Kosobud, Douglas L. Schreder, Holly M. Biggs, *Emissions trading: environmental policy's new approach* (2000).
- Jonas Monast, Jon Anda, and Tim Profeta, *U.S. Carbon Market Design: Regulating Emission Allowances as Financial Instruments*, Nicholas Institute Paper CCPP 09-01 (2009)
- Lydia Olander, *Designing Offsets Policy for the U.S.*, Nicholas Institute Paper NI R 08-01 (2008).
- Testimony of Jon A. Anda before the Subcommittee on Energy and the Environment, House Energy and Commerce Committee, April 24, 2009, available at http://energycommerce.house.gov/Press_111/20090424/testimony_anda.pdf
- Various Authors, *Mitigation Beyond The Cap: A Series of Briefs on Expanding Climate Mitigation Opportunities*, Nicholas Institute Policy Briefs, 08-01A, 08-01B, 08-01C, 09-03 (2008 and 2009)

**Testimony of the
USA Rice Federation
and the
US Rice Producers Association**

**Before the U.S. Senate
Committee on Agriculture, Nutrition, and Forestry**

**To Review Global Warming Legislation: Carbon
Markets and Producer Groups**

September 9, 2009

Introduction

Chairman Harkin, Senator Chambliss, and members of the Committee, thank you for holding this hearing on climate change legislation and carbon market issues. We appreciate the opportunity to offer testimony before the Committee on Agriculture, Nutrition, and Forestry concerning rice industry views on climate change legislation.

My name is Frank Rehermann and I offer this testimony on behalf of the USA Rice Federation. I currently serve as chairman of the USA Rice Producers' Group and vice chairman of the USA Rice Federation and am a rice farmer from Live Oak, California. My wife and I operate our farm as a family partnership growing 800 acres of rice in the Sacramento Valley. I have been farming since 1972.

U.S. Rice Industry Overview

The USA Rice Federation is the global advocate for all segments of the United States rice industry with a mission to promote and protect the interests of rice producers, millers, merchants, and other allied businesses that comprise much of the multibillion dollar U.S. rice industry. The US Rice Producers Association represents rice producers in all 6 of our major rice producing states. Together, USA Rice and the US Rice Producers Association represent virtually the entirety of the U.S. rice industry – from farmers to processors to marketers to exporters. The rice industry provides jobs and income for not only producers and processors of rice, but for all of these parties in the value chain.

Rice is planted on about 3 million acres in six states, including Arkansas, California, Louisiana, Mississippi, Missouri, and Texas. The U.S. rice industry is unique in its ability to produce all types of rice, from long grain, medium grain, and short grain, to aromatic and specialty varieties. Last year, U.S. farmers produced a rice crop of nearly \$3.4 billion in farm gate value.

Today, about 81 percent of all the rice that is consumed in the U.S. is produced here at home. And, despite U.S. and foreign trade barriers to U.S. rice exports, the U.S. remains the largest non-Asian exporter of rice and the third largest exporter worldwide. On average, between 40 to 50 percent of the U.S. annual crop is exported as either rough or milled rice.

The United States' top export markets for rice include Mexico, Japan, Iraq, Haiti, Canada, and most of Central America. In 2008 we exported over \$2.2 billion in rice to markets around the world.

Americans consume 25 pounds of rice per person per year. Of the rice produced by our farmers that remains in the domestic market, 53% is bound for direct human food use and 16% dedicated to processed foods, 15% for beer, 14% for pet food, and the remaining for industrial uses.

The 2005 Dietary Guidelines and MyPyramid recommendation, published jointly by the Departments of Agriculture and Health and Human Services, call for 5 to 10 servings of grains daily, with half the servings coming from whole grains, such as brown rice, and 45 to 65 percent of calories coming from complex carbohydrates, such as rice. Rice is a wholesome source of nutrition, with no sodium, no cholesterol, no glutens, and no trans or saturated fats.

Beyond the substantial economic and nutrition benefits of rice is the environmental dividend from winter-flooded rice fields that provide critical habitat for migratory waterfowl and other wetland-dependant species. All the major rice-production areas in the U.S. correspond with important areas of waterfowl activity during winter months. Rice-growing areas provide surrogate habitats for hundreds of wildlife species that rely on wetland conditions for species survival, some of which are currently or could be threatened if not for the wetland environments provided by flooded rice fields. Without rice farming, wetland habitats in the U.S. would be vastly reduced. A loss of this magnitude would have a disastrous effect on waterfowl, shore birds, and a host of other wetland-dependant species.

Rice Industry Concerns with Climate Change

The climate change legislation pending before Congress is not supported by the U.S. rice industry. With respect to the American Clean Energy and Security Act (H.R. 2454) that narrowly passed the U.S. House of Representatives earlier this summer, we supported the efforts of House Agriculture Committee Chairman Collin C. Peterson and other Members of the House who worked to mitigate the bill's adverse impacts on agriculture. But neither of our organizations supported passage of the bill as amended.

Unfortunately, despite these efforts, the costs of this legislation still heavily outweigh any potential benefits, leaving us no choice but to strongly oppose the legislation. Simply put, at a time when America's rice farmers are already facing significant production costs and are forced to compete on an uneven global playing field, climate change legislation would add insult to injury.

One of the key areas of focus in our analysis of the legislation has been the impact on rice production costs as a result of higher costs for major inputs such as fuel, electricity, fertilizer, natural gas, and propane. Rice is flood irrigated, requiring energy to pump either ground or surface water. In addition, rice is a high yielding crop utilizing nitrogen fertilizer which, in turn, is made using natural gas. Furthermore, all rice must be dried before it can be stored. Finally, beyond the increased costs of field production, U.S. rice must also be milled before it can be consumed or utilized in products. All of these already significant costs are expected to substantially increase, both in the short and long term, under climate change legislation and this does not take into account increased transportation costs and other costs due to rise as a result of this legislation.

Increased input costs will make us less competitive vis-à-vis our major global competitors, such as Vietnam, Thailand, Pakistan, and India, who already benefit from heavy government involvement in their rice production. Congress should not approve legislation that will have the effect of shifting rice production overseas to foreign competitors that are made the lower cost producer solely because of the policies of our own government. Such a move would result in the loss of thousands of American jobs in the rural areas of the Mississippi Delta, the Louisiana and Texas Gulf Coast, and the Sacramento Valley of California. These areas rely, to a large extent, on the U.S. rice industry to support their local economies and jobs. Shifting our agriculture production overseas and becoming dependant on other countries for food production will only threaten our nation's food security.

Regarding the role that U.S. agriculture can play in reducing greenhouse gas emissions, while, in the net aggregate, U.S. agriculture sequesters more greenhouse gases than it emits, there are currently few, if any, opportunities for rice production to further sequester or reduce greenhouse gases.

That is not to say that due diligence is not being done to investigate ways in which rice might meaningfully contribute to greenhouse gas sequestration or reduction in the future. In fact, work is currently underway in California to develop computer-modeling techniques to quantify greenhouse gas emissions. Once complete, this model will also predict the greenhouse emissions response to certain changes in cultural practices. Current pilot-scale activities are being implemented to evaluate potentially beneficial activities. Both implementation challenges and impacts on yield and production costs will be evaluated to see if any ideas are ultimately deemed feasible.

If efforts in California are successful, greenhouse gas sequestration and reduction would be added to the long list of contributions to conservation already provided by rice producers including the provision of wetlands for hundreds of wildlife species as well as migratory birds in the Mississippi, Central, and Pacific flyways. We are simply not there yet on sequestration.

So, we are confronted with no economic upside under pending climate change legislation and plenty of economic downside. For instance, a recent analysis by the Agricultural and Food Policy Center at Texas A&M University estimates that due to the increase in input costs for rice and the likelihood of no opportunity to participate in an offset credit program at this time, all 14 representative rice farms analyzed would experience lower average annual net cash farm income ranging from \$30,000 to \$170,000 in reductions per operation. Annual costs for these farms increase from \$20,000 to \$120,000 during the 2010 to 2016 period. And while the commodity price is expected to increase slightly it is not enough to make up for the significant cost increases. The American Farm Bureau Federation also estimates that the *increase* in rice production costs per acre could reach as high as \$153.00. That's not the difference between a large profit and a lean profit. That's the difference between break even and broke.

At a time when U.S. farm income is already projected to be down 38% from last year and given the condition of the U.S. economy overall, we are deeply concerned about where this legislation would position us in the global economy, particularly since it is highly unlikely that our key global competitors will impose an equally rigorous regulatory regime on their own industries if our past trade agreements are any indication. In fact, recent reports that some in the developing world are calling on developed nations to make sharp reductions in greenhouse gas emissions while insisting that they not be bound to any specific level of reductions is ominously familiar to those of us closely observing WTO Doha Round discussions.

As such, we would strongly urge the Members of this Committee to fully evaluate alternative approaches to curbing greenhouse gas emissions and to oppose pending or similar climate change legislation. In this vein, we wish to express our gratitude to the Members of this Committee who have urged that the cap and trade provisions of climate change legislation be dropped entirely. To be sure, there are ways to reduce greenhouse gas emissions and reduce our dependence on oil-exporting countries without crippling the U.S. economy. Focusing on energy

efficiency measures and additional renewable and clean energy development are just a few of these avenues.

Recommendations to Improve Climate Change Legislation

If, however, pending or similar climate change legislation is ultimately considered in the Senate, we believe there are several key provisions that must be clearly and explicitly included in the bill to help ensure U.S. agriculture is not irreparably injured in the process. These key provisions include:

- An express exemption should be provided for the agriculture sector from the greenhouse gas emission reduction requirements of the climate change legislation and the underlying Clean Air Act.
- The definition of "agriculture sector" for purposes of this exemption should be clarified to include production through the stage of processing ordinarily necessary for the commodity to be widely marketed in commercial channels.
- Increased funding should be provided for research programs and activities by USDA and the land grant university system to develop improved production and management practices and technologies to help agriculture sequester greenhouse gas emissions, with a particular focus on research for those crops that currently have little or no opportunity in this regard.
- Establishment of a program using the funds and authorities of the Commodity Credit Corporation to compensate producers for increased input costs.
- Establishment of a robust agricultural offset program that is flexible and run entirely by USDA, not the EPA.

Conclusion

In conclusion, on behalf of the U.S. rice industry, I strongly urge this Committee to work with the Senate leadership to postpone consideration of climate change legislation until such time that alternative legislative approaches to curbing greenhouse gas emissions are developed which do not injure American agriculture or the U.S. economy, generally. If this effort is unsuccessful, then we respectfully request that this Committee work with the other committees of jurisdiction and your Senate colleagues to ensure that the provisions provided above are included in any climate change legislation that is enacted into law. We believe that, without these provisions, the current approach to climate change would be catastrophic to American agriculture.

Thank you for the opportunity to provide our views. I would be happy to respond any questions.

**Statement of
Julie Winkler,
Member of the Board of Directors, Green Exchange Venture
Before the
Senate Committee on Agriculture, Nutrition and Forestry
Hearing on Regulating Carbon Markets
in a Cap-and-Trade System**

September 9, 2009

I am Julie Winkler, Managing Director of Research and Product Development of CME Group Inc. ("CME Group") and Member of the Board of Directors of the Green Exchange LLC. The Green Exchange Venture appreciates the opportunity to provide its views to the Senate Committee on Agriculture, Nutrition and Forestry regarding the design and regulation of a U.S. carbon market.

We believe that cap-and-trade is the preferred solution for guaranteeing emissions reductions at the lowest possible cost to the economy. We strongly support providing compliance entities with a choice of utilizing exchange traded derivatives and over-the-counter ("OTC") instruments with additional transparency to meet their environmental obligations. Also to provide these customers with effective risk management tools and liquidity, the U.S. carbon markets must allow for broad market participation. We believe that the Commodity Futures Trading Commission ("CFTC") is best suited as the regulator of the U.S. carbon market and they will ensure a transparent and effectively regulated carbon market. Lastly, to ensure the use of transparent markets and central clearing services and the necessary liquidity and price discovery they provide, regulatory proposals should not include a transaction tax on carbon derivative exchanges.

Green Exchange Venture

CME Group is a founding member of the Green Exchange Venture along with Evolution Markets, Credit Suisse, Goldman Sachs, JP Morgan, and Morgan Stanley. The founding members are joined by partner firms from across the energy, environment, and financial sectors: Constellation Energy, ICAP, RNK Capital LLC, Spectron, TFS, Tudor Investment Corp. CME Group currently provides the electronic trading platform, Central Counterparty Clearinghouse ("CCP") services, market data distribution, and regulatory services to the Green Exchange Venture. CME Group is the world's largest and most diverse derivatives marketplace and through its subsidiaries operates four separate Exchanges: Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City

of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX").¹

CME also operates CME Clearing, one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for OTC derivatives contracts through CME ClearPort®. CME ClearPort provides clearing services to eligible participants, mitigates counterparty risk and brings OTC transactions within the regulatory oversight of the CFTC.

While the Green Exchange Venture was formally launched as a standalone entity this year, CME Group and the other Green Exchange Venture partners bring more than a century of experience in building markets to meet the risk management needs of commercial and financial participants.² The Green Exchange Venture member firms have been actively involved in designing and participating in all major environmental markets around the world, including U.S. emissions cap-and-trade programs for sulfur dioxide ("SO₂") and nitrogen oxide ("NO_x"), the global renewable energy trading markets, the European Union ("EU") Emissions Trading System ("ETS"), and the global carbon offset market.

Following CFTC review and approval of our application for contract market designation³, the Green Exchange product slate will include futures and options on European Union Allowances ("EUA"), Certified Emission Reductions, SO₂ Allowances, NO_x Allowances, and Northeastern Regional Greenhouse Gas Initiative Allowances (RGGI). These environmental contracts are highly flexible financial instruments useful to qualified market participants to meet their risk management needs. As an example, our EUA futures contract represents one-thousand EUA allowances, equaling one ton of emissions. Our product slate will also be expanded to include derivatives based on a U.S. cap-and-trade program if such legislation is approved. Until the contract market designation is obtained by Green Exchange, environmental futures and options products are trading on the NYMEX through the CME Globex® electronic trading platform and listed for clearing on CME ClearPort.

¹ The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

² The CBOT became involved in the U.S. emissions market in 1993 when it was chosen by the Environmental Protection Agency (EPA) to administer the SO₂ auctions. After an objective selection process, the CBOT was chosen to run the auctions because of its demonstrated ability in handling and processing financial instruments and using transactional information systems. The CBOT was not compensated for these services by EPA and administered this innovative auction in partnership with the EPA for 12 years.

³ Upon approval as a Designated Contract Market (DCM), the Green Exchange Venture will become a self-regulatory organization (SRO) with frontline market and trade practice surveillance responsibilities, subject to oversight by the CFTC. As an SRO, the Green Exchange Venture will be required to adopt and enforce rules to effectuate 18 core principles. It will be required to monitor trading activity, enforce rules, take appropriate disciplinary action, monitor deliverable supplies, detect and deter manipulation, among other things to ensure the integrity of the markets.

Lastly, we are actively engaged in discussing the U.S. climate policy; the CME Group was recently invited to join the Pew Center on Global Climate Change's Business and Environmental Leadership Council -- a partnership of 45 companies including Fortune 500 energy, manufacturing, and other companies. We believe that our insights from other markets and our understanding of the policy debate surrounding the creation and oversight of environmental markets, provides a crucial perspective on the carbon market policy discussion.

Reducing Emissions through a Cap-and-Trade System

Scientists believe that climate change is a global threat that requires a response to bring about substantial reductions in carbon dioxide and other greenhouse gas ("GHG") emissions. According to the 2007 Intergovernmental Panel on Climate Change ("IPCC") report, the global average temperature could rise by 2.4-6.4°C by the end of this century if no corrective action is taken.⁴ This would lead to serious consequences from both an environmental and economic perspective for developed and developing countries.

A market-based solution, such as a cap-and-trade program, offers the best opportunity to minimize the cost of mandatory reductions in GHG emissions. The U.S. Climate Action Partnership ("USCAP"), an alliance of major businesses and leading climate and environmental groups, has stated that "cap-and-trade is essential" and "allows the economy-wide emission reduction target to be achieved at the lowest possible cost."⁵ In a cap-and-trade system, one allowance would be created for each ton of GHG emissions allowed under the declining economy-wide emission reduction targets (the "cap"). Those emitters who can reduce their emissions at the lowest cost would have to buy fewer allowances and may have extra allowances to sell to remaining emitters for whom purchasing allowances is their most cost-effective way of meeting their compliance obligation. Like USCAP, leading environmental and nature resource groups such as the Natural Resource Defense Council, Environmental Defense Fund and the Pew Center on Global Climate Change are supporting U.S. cap-and-trade.⁶ Additionally, agriculture organizations such as National Farmers Union also view cap-and-trade as the preferred approach for reducing emissions.⁷

Cap-and-trade in the U.S. is not a new mechanism as the U.S. was the global leader in utilizing a market-based solution to establish the Acid Rain Program under the 1990 U.S. Clean Air Act Amendments. The SO₂ trading system has been regarded as an innovative solution, which is achieving its stated goals of reducing overall atmospheric

⁴ IPCC. "Climate Change 2007: Synthesis Report." Published by the IPCC on Climate Change. 2008.

⁵ USCAP. "A Call to Action. Consensus Principles and Recommendations from USCAP: A Business and NGO Partnership." 2009.

⁶ Environmental Defense Fund. "The Case for Cap-and-Trade." July 23, 2009.

⁷ Testimony of Roger Johnson, President, National Farmers Union. "Concerning the Role of Agriculture and Forestry in Global Warming Legislation" before the Senate Committee on Agriculture, Nutrition and Forestry on July 22, 2009.

levels of SO₂ and NO_x.⁸ The EPA also estimates that by 2010, the overall compliance costs to businesses and consumers will be \$1-2bn per year, one quarter of the original one quarter of the originally predicted cost.⁹

In January 2009, ten Northeastern and Mid-Atlantic States launched the first mandatory, market-based effort in the United States to reduce GHG emissions called the Regional Greenhouse Gas Initiative (RGGI). This program aims to reduce capped CO₂ emissions from the power sector and will require a 10 percent reduction in these emissions by 2018. Alongside the allowances and offsets trading in the RGGI program, there are both derivative and OTC contracts being traded by market participants.

In the EU, the ETS is the largest cap-and-trade program in the world currently covering more than 12,000 installations in the energy and industrial sectors, which account for approximately 40% of the EU's emissions of CO₂ and other GHGs. Since 2005 when the first trading period for ETS began, transaction volumes have grown by almost ten times.¹⁰ With respect to carbon emissions, initial evidence from the EU ETS demonstrates that leading companies subject to the caps are utilizing the carbon markets to effectively reduce emissions. According to a July 2009 Global Carbon Trading Study, it is estimated that global carbon trading could reduce the cost of emissions reductions by up to 70% in 2020 compared to a carbon cap without a trading component.¹¹

Cap-and-trade programs are proving that they can successfully cut emissions with efficiency and cost effectiveness. Emissions trading systems are already operating or planned in over 35 countries in the developed world.¹² Clearly, the global carbon trading is expanding rapidly and the U.S. would not want to miss the opportunity to play a defining role in this market's growth.

Cap-and-Trade Design Features

There are several design features that are critical to a well-functioning cap-and-trade system such as establishing an accurate emissions baseline, determining how allowances are to be auctioned or distributed, and collecting and disseminating market data. Based on our extensive market development experience, the Green Exchange Venture partners also strongly believe that a cap-and-trade system must include broad market participation and not be constrained by artificially created carbon price constraints.

⁸ Between 1990 and 2007, SO₂ emissions decreased by 43% and the 2010 emissions target was reached three years early.

⁹ Ellerman, A. Denny and Paul L. Joskow. "The European Union's Emissions Trading System in Perspective." Prepared for the Pew Center on Global Climate Change. May 2008.

¹⁰ Ellerman, A. Denny and Paul L. Joskow. "The European Union's Emissions Trading System in Perspective." Prepared for the Pew Center on Global Climate Change. May 2008.

¹¹ Lazarowicz, Mark. "Global Carbon Trading – A Framework for Reducing Emissions." Prepared for the United Kingdom Prime Minister. July 2009.

¹² Current ETSs in production and under development in other countries plan to result in 17-35% reductions in global emissions being covered under these programs by 2015.

For a cap-and-trade system to work effectively, the carbon market must have participation beyond compliance entities. A market that includes liquidity providers such as financial intermediaries and offset aggregators from the onset will ensure that buying and selling occurs on a routine basis as various market participants express different views on the market. These types of participants also provide essential market services to their clients, compliance entities, by assisting in managing price risk, providing financing for emissions reduction activities, and in general engaging in large-scale capital deployment which can reduce compliance costs.

Government imposed price floors or ceilings should be avoided if a carbon market is to play its role in creating meaningful price discovery. Price caps reflect factors extraneous to the fundamental factors that drive prices, and thus are not connected to actual supply and demand. While it may seem that artificially constraining prices with a ceiling will reduce price volatility or market manipulation, the opposite is likely to result. With a ceiling derived from non-market based factors lying idle above a market price, the free flow of buying and selling can be overshadowed by the knowledge that there is a flood of allowances to be unleashed at the ceiling price. The reverse could take place at price levels close to a floor, where demand automatically and arbitrarily surges.

A price cap would not only interfere with the generation of a meaningful market price for carbon, it would also discourage low-carbon energy and agricultural offset investors from participation in the market since they would be unable to benefit from increased prices for offset credits. Lastly, a price cap would interfere with the maturing of a global carbon market since if implemented in one jurisdiction and not others, it will distort pricing relationships.

We fully understand the motivation to protect American consumers from dramatic increases in the cost of carbon, however, the dynamics associated with price floors and ceilings would undermine the overarching intent of a cap-and-trade program.

The Functions of Cash and Derivatives Markets for Carbon Trading

If a federal cap-and-trade program is enacted by Congress, a price on carbon will become a new input cost for the energy and industrial sector and a new revenue source for agricultural offset providers who supply carbon offsets into the market. The carbon price will fluctuate as market participants' perceptions of the supply and demand balance of allowances, as well as the cost of compliance alternatives, evolve over time. The two primary markets created will be: 1) a cash market to allow for the trading of allowances and offset credits; and 2) the derivatives market to allow for the trading of allowance and offset derivatives.

Allowance supply is determined by the government imposed cap and therefore is unlike most commodities. This is unlike existing and more mature commodity markets where supply is determined from various entities and external factors. Confidence in

market integrity is crucial both to effective functioning of the market and ongoing support of a market approach among both policy makers and the general public. Therefore, an essential component of the cash carbon market will be a robust registry system to track creation, ownership and retirement of allowances and offsets credits. Registries play an important role in ensuring market integrity, tracking progress toward environmental goals, and facilitating delivery for environmental commodities.

As a complement to the cash market, allowance derivatives contracts such as futures offered by the Green Exchange Venture will enable capped entities to manage U.S. carbon price movements and deploy capital for new energy projects with a greater level of certainty. For example, a risk manager working for a compliance entity, who knows she will need to purchase allowances for compliance at a specific time in the future, can lock in a price by purchasing the appropriate number of carbon futures contracts on the exchange. If the price rises, the manager will pay a higher price for the actual allowances in the cash market, but will earn a corresponding and offsetting profit on the futures position.

In addition, buyers of futures contracts can, if they choose to, take delivery of the cash allowances by holding the position until contract expiration. In this case, the buyer may be able to contract for a future supply of allowances at a lower price than what might be available upon eventual delivery, thereby lowering compliance costs. These deliveries are managed by the clearinghouse, which maintains an account with the emission registry involved in the delivery process.¹³

A compliance entity who anticipates having an excess of cash allowances as a result of the firm's efficiency in reducing emissions below its cap, can lock in a price in advance by selling futures contracts in the appropriate amount. A seller of the futures contract also can maintain their short position and deliver allowances against the contract.

The Role of Futures Exchanges, CCP Solutions and Regulators in a U.S. Carbon Market

Futures markets perform two essential functions—they create a transparent venue for price discovery and they permit low cost hedging of risk. Futures markets depend on a broad universe of market participants with both short and long term expectations to make markets and provide liquidity for hedgers. By offering trading of U.S. emission derivatives on electronic trading platforms, we believe exchanges will enhance price transparency, speed execution, and eliminate many classes of errors and mismatched trades, contribute significantly to liquidity, and will generally be beneficial to the market.

Electronic trading of exchange traded emission derivatives coupled with a comprehensive CCP solution such as the one offered by CME Clearing and utilized by the Green Exchange Venture, will reduce risk and uncertainty for carbon market participants. CME Clearing has provided clearing services for the futures industry for

¹³ The clearinghouse also guarantees the integrity and completion of delivery of the allowances.

over a century without a single default and has an industry-leading financial safeguards package of over \$7 billion that is designed for the benefit and protection of both clearing members and their customers.¹⁴

Electronic trading and CCP solutions will also provide a trustworthy and timely audit trail for regulatory purposes. In providing market and trade surveillance services to the Green Exchange Venture, the CME's dedicated and highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Through advanced technology tools, we have an audit trail that allows us to effectively identify anyone who engages in misconduct. CME also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Over the past year, CME worked closely with the CFTC and other exchanges to transition to standardized trade data reporting to the CFTC.¹⁵ These data files provide critical and timely data to the CFTC and the Green Exchange Venture is committed to continuing this practice for trading activity in our emissions products. Additionally, the CFTC receives large trader positions directly from each clearing firm on a daily basis to monitor activity and prevent market manipulation.

The CFTC assures the economic utility of the futures markets by encouraging competitiveness, protecting market participants against fraud, manipulation, and abusive trading practices, and by ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important functions of price discovery and hedging price risk. To ensure the adequacy of exchange SRO programs, the CFTC conducts routine rule enforcement reviews of each futures exchange. In the context of the rule enforcement reviews, the CFTC reviews the exchanges' trade practice and market surveillance programs, disciplinary programs and audit trail. These reviews are comprehensive and the findings and recommendations are public documents.

We believe that because of the CFTC's established expertise and coordination within the global derivatives industry, it is in the best position to provide strong regulatory oversight to a mandatory U.S. cap-and-trade market. We applaud the efforts of this Committee and the Administration to ensure that a mandatory U.S. GHG cap-and-trade program will enhance transparency, integrity, efficiency and fairness in the markets.

¹⁴ The CME Clearinghouse currently holds more than \$100 billion of collateral on deposit and routinely moves more than \$5 billion per day among the CME Clearinghouse and its clearing firms. It conducts real-time monitoring of market positions and aggregate risk exposures, twice-daily financial settlement cycles, advanced portfolio-based risk calculations, monitors large account positions, and performs daily stress testing.

¹⁵ Earlier this year, the CME and CBOT became the first exchanges to begin reporting trade data using the FIXML Trade Capture Report format to the CFTC.

Price Transparency and Market Data Distribution

Another important aspect to an effective cap-and-trade program is access to price data for market participants, emitters, regulators, and the general public. Our real-time futures price data is disseminated to approximately 400,000 real-time data subscribers through 40 directly connected quote vendors and an additional 200 licensed vendors¹⁶. The technology employed allows for real-time market data to be disseminated in 5-10 milliseconds from the time it leaves our electronic trading system. Additionally through www.cmegroup.com, we provide free, delayed price quotes for all of our futures products.¹⁷ We strongly believe that the existing market data infrastructure, standard FIX/FAST formats, and reliability of our quote distribution technology, can provide the price transparency required to support the U.S. carbon market. This data feed can also facilitate the real-time transfer of price data to regulators with very little additional effort or cost. In our view, creating a new infrastructure for this purpose for the carbon market would be complex and costly for federal government and participants alike, which could be ultimately detrimental to establishing U.S. leadership in addressing global environmental challenges.

OTC Transactions

As beneficial as exchanges and clearinghouses will be to the formation of an effective U.S. carbon market, they will not meet all of the needs of companies seeking to meet their compliance targets. Although the Green Exchange Venture and other emissions trading platforms would likely be the presumed beneficiaries if all transactions were required to be executed on electronic trading platforms, we do not believe such a requirement would be in the best interest for a U.S. cap-and-trade program to meet its goal of cost-effectively reducing emissions.

We believe that both exchange-traded and OTC derivatives markets are essential to the efficient functioning of a U.S. carbon market. Together, these markets can provide compliance entities with the ability to increase the certainty in their future cash flows by protecting against price risks and effectively managing their capital, thereby increasing their confidence and ability to act and reducing their overall cost of compliance. Given the multitude of unique contracts traded in the OTC market and the specialized customer needs, we strongly believe that customers must be given the ability to access both exchange traded derivatives and OTC markets, if they are to effectively manage their price risk. A government mandate for exchange trading of standardized contracts as a replacement for this bespoke market will increase costs for entities with compliance obligations, and impede the ability of developers of both projects and new technologies to obtain financing on reasonable terms.

¹⁶ This data is sent on behalf of the four exchanges operated by CME Group, which include CME, CBOT, NYMEX and COMEX. CME also handles market data distribution and licensing administration services for the Green Exchange Venture.

¹⁷ In August 2009, www.cmegroup.com received approximately 9.2 million hits per day and 43% of these hits viewed quote pages for commodity products.

The OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies¹⁸. OTC arrangements are particularly crucial for financing carbon offset projects and the sale in the first instance of the created carbon offsets. Primary offset creation contracts provide the supply of offsets necessary to help contain the costs of a climate program for American consumers. Each of these carbon offset creation contracts is unique, and their customized nature lends itself to the OTC market, not exchanges.

Another example of a vital customized transaction for U.S. carbon markets would be long-term structured transactions. These transactions hedge price risk associated with investments in emissions reduction and clean energy technologies. Companies financing such investments base the repayment of loans, in part, on the cost of carbon allowances or offsets. This leaves such financing vulnerable to swings in carbon prices, which is a risk that must be hedged for financing to take place. Again, such transactions are specific to each investment and are often of such long duration that they cannot be effectively traded on an exchange.

Finally, OTC markets support the healthy functioning of exchanges themselves. Historically, products that are today traded on exchanges have started as OTC products. It is only after an OTC product achieves a degree of standardization and attains a critical mass of acceptance that it meets the qualifications for listing on an exchange. Eliminating OTC transactions could cause damage and disruption to the evolution of standardized exchange traded products.

While some types of customized transactions must be conducted OTC, the natural tendency of the majority of trades will be to gravitate to exchanges, and to utilization of clearing services, with or without any legal requirement to do so. Carbon market participants will be attracted to trading platforms that provide the highest level of liquidity and transparency, the best risk management opportunities, and highest level of financial assurance. This is currently being seen in the functioning carbon market in the EU. Carbon trading in the EU ETS began with transactions taking place exclusively OTC. In relatively short order, exchange-traded products developed. Over the last two years a distinct trend has emerged with increased liquidity on carbon exchanges and enhanced use of CCPs. According to market participants, it is estimated that over 40% of ETS EUA futures contracts are exchange traded and a predominance of OTC transactions are cleared through CCPs. All of this is occurring without any legal or regulatory requirement to do so. The EU example demonstrates not only the importance of

¹⁸ Exchange cleared transactions require posting of collateral so for some entities, the OTC market can provide more flexible financing arrangements that provide needed financial security without requiring cash. An easy to understand example would be taking a lien, or "mortgage" against the physical assets of a counterparty. This "cashless" form of collateral can be of great benefit to a project developer, a manufacturer developing a new technology, or even an established business needing to conserve cash.

exchanges in carbon market trading, but also the vital role that OTC markets play in the market's initial development – and its continued importance for customized transactions.

Improved Transparency in OTC Carbon Markets

Our view is that efficiently functioning derivative markets are essential to risk management, and that it is entirely appropriate to focus on how to improve the efficiency and security of the OTC derivative market. CME Group and the Green Exchange Venture are strong proponents of the benefits of centralized clearing of OTC derivatives as an effective means of reducing systemic risk while at the same time collecting and providing timely information to regulators. Our view derives from considerable experience acting as a central clearing party for exchange traded derivatives, and more recent experience acting in the same role for OTC derivatives based on energy and agricultural commodities.

While OTC transactions must be present in a carbon market for cap-and-trade to be fully successfully, the OTC carbon market must provide a greater level of transparency than what is currently present in some other OTC markets. We support position reporting for carbon-related OTC transactions to provide enhanced transparency. Indeed, as part of its special call reporting, the CFTC already requires extensive reporting of OTC commodity derivative positions. This framework can be leveraged and extended to include new carbon derivatives. We also recognize that this Committee, the Administration, and others are evaluating regulatory changes to the broader OTC derivatives market. We believe that any regulatory framework created for the U.S. carbon market should be crafted to be consistent with regulatory changes that may be made to the broader OTC derivatives markets.

Ensuring the Cost Effectiveness of Carbon Trading and Clearing

In effectively regulating a potentially large carbon market, the CFTC may need additional resources. However, the Committee should resist any proposal to add a transaction tax to carbon derivatives transactions. A transaction tax would directly increase the cost of doing business for the compliance entities and essential liquidity providers that will use carbon derivatives. This tax will expose them to the choice of trading on the exchange at a profit level that is unjustified for the risks assumed and likely result in them trading elsewhere. The exit of market participants will mean decreased efficiency of the futures markets, more price volatility and less opportunity for other market participants to make effective use of futures markets. Moreover, futures markets provide significant benefits to market users and to persons seeking meaningful information on future pricing in order to guide their decision making on clean energy investment and offset development. More depth and liquidity in a carbon futures market will lead to better price discovery. Any impairment of liquidity lessens the value of the information and the functioning of our markets.

A transaction tax will also discourage the use of centralized clearing. At a time when the markets are searching for increased transparency and safeguards, a transaction tax applied to the settlement of derivative contracts cleared by a Derivatives Clearing Organization (DCO), would essentially penalize those using a regulated U.S. DCO and discourage the growing use of CCP solutions. This is in direct conflict with the Administration's goal of improving the role of regulators in monitoring systematic risk.

We recognize the need to ensure that CFTC has adequate resources to effectively oversee a potentially sizable carbon market, but we strongly believe that a transaction fee on derivatives will discourage the use of the risk management tools available on transparent exchanges which will ultimately drive up the costs of a cap-and-trade program through diminished liquidity and decreased price signals.

Conclusion

Cap-and-trade is the most efficient approach to significantly reducing emissions. Entities such as the Green Exchange Venture will provide capped entities and other market participants with the venue to safely and securely manage their carbon price risks. Such exchanges and CCPs should be unimpaired from transaction taxes that could damage liquidity and discourage their use. Regulated exchanges, CCP solutions, and the CFTC, will provide a high level of transparency to the U.S. carbon markets. This existing transparency combined with added transparency to the OTC market will ensure a well-functioning carbon market that will enable compliance entities to meet their environmental obligations and agricultural and forestry offset developers to fully participate in the carbon market.



National
Corn Growers
Association
www.ncga.com

**Committee on Agriculture, Nutrition and Forestry
United States Senate**

Hearing on

**Global Warming Legislation:
Carbon Markets and Producer Groups**

Testimony of

**Fred Yoder
National Corn Growers Association**

September 9, 2009

Chairman Harkin, Ranking Member Chambliss and distinguished members of the Committee, thank you for the opportunity to testify today on behalf of the National Corn Growers Association (NCGA) regarding carbon markets. I applaud the committee's efforts to focus attention on the important role the agriculture industry has in the area of climate change and the issues facing rural America.

The National Corn Growers Association represents more than 35,000 corn farmers from 48 states as well as more than 300,000 farmers who contribute to corn check off programs and 26 affiliated state corn organizations across the country. The mission of NCGA is to create and increase opportunities for corn growers and to enhance corn's profitability and use.

My name is Fred Yoder, and I am a past president of NCGA. I grow corn, soybeans and wheat near Plain City, Ohio and have been an active participant in climate change discussions for many years. In December, I had the opportunity to attend and participate in the United Nations World Climate Conference in Poland where I was able to discuss the role of agriculture in reducing greenhouse gas emissions. In addition to being part of NCGA's efforts, I serve on the boards of numerous ad hoc groups, including the 25x25 Carbon Working Group and the Ag Carbon Market Working Group.

We are pleased that the Senate Agriculture Committee is actively involved in the climate change negotiations in Congress. Agriculture should be considered a significant part of the broader solution as we evaluate ways to reduce greenhouse gas emissions. Our nation's corn growers should have the opportunity to make significant contributions under a market based cap and trade system through sequestering carbon on agriculture lands. In fact, numerous economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program for consumers.

In the near term, greenhouse gas reductions from livestock and agricultural conservation practices are the easiest and most readily available means of reducing greenhouse gas on a meaningful scale. The United States Environmental Protection Agency (EPA) estimates that agricultural and forestry lands can sequester at least 20% of all annual greenhouse gas emissions in the United States.

Further, agricultural producers have the potential to benefit from a properly crafted cap and trade program. Given these opportunities, it is critical that any climate change legislation seeks to maximize agriculture's participation and ensure greenhouse gas reductions while also sustaining a strong farm economy.

For years, corn growers along with the rest of the agriculture industry have adopted conservation practices such as no till or reduced tillage, which result in a net benefit of carbon stored in the soil. In fact, on my farm, I engage in both no till and reduced tillage. Also, for the past five years, I have worked with my state association, the Ohio Corn Growers, on a research project with Dr. Rattan Lal of Ohio State University on soil carbon sequestration. As part of our efforts, we have on-farm research plots at six different locations to study various soils and their carbon capture capabilities. I have

been actively engaged from the beginning in defining the research protocols. This is only one example of the groundbreaking work our industry is undertaking.

NCGA has identified several priorities which I believe are critical elements to the agricultural sector within cap-and-trade legislation. We have worked closely with others in the industry to identify key principles which have been embraced by a broad cross-section of the agriculture community. A number of these priorities were addressed in the final House passed version of H.R. 2454. NCGA currently has a neutral position on the legislation while we conduct an economic analysis of the House passed bill. We expect to have preliminary results of our study in the coming weeks, which will better explain the potential cost increases and income opportunities for corn production under a cap-and-trade system.

First, NCGA supports the decision by the House of Representatives to exclude agriculture from an emissions cap, and we urge the Senate to maintain this important exemption. Any efforts to regulate greenhouse gas emissions from America's two million farms and ranches would be costly and burdensome, resulting in limited reduction of greenhouse gas emissions. Our industry accounts for only 7% of emissions in the overall economy. Therefore, it would seem unreasonable to concentrate on regulations for such a small and diffuse industry.

However, tremendous environmental benefit can be achieved by allowing producers to provide low-cost, real and verifiable carbon offsets. Congress should fully recognize the wide range of carbon mitigation or sequestration benefits that agriculture can provide. This could include sequestration of carbon on agricultural lands, reduction of emissions from livestock through dietary improvements and manure management, introduction of nitrogen and other fertilizer efficiency technologies and a variety of other practices.

In addition, agricultural offsets have the ability to significantly lower the cost of a cap-and-trade system while achieving real greenhouse gas emissions. Corn growers and other producers can provide the offsets needed to allow changes in energy production technologies as well as investments in capital and infrastructure to occur, while providing market liquidity and low-cost emissions reductions to help the market function properly. Furthermore, agricultural offsets could also spur ancillary environmental benefits in the form of clean water, air and better wildlife habitat, while at the same time enhancing the fertility and productivity of the soil resource needed to provide food, feed, fuel and fiber. Farmers have always and will continue to respond enthusiastically to market incentives.

Of course, NCGA is closely monitoring the macro-economic impacts of cap-and-trade legislation to ensure that new policies do not create an unnecessary burden for the nation's agriculture sector. We fully anticipate that the cost of fertilizer, fuel, machinery and other inputs to increase under a cap-and-trade system. Corn growers are subject to the volatility of the commodity markets with little ability to recoup costs associated with escalated input prices. Therefore, to ensure a vibrant U.S. agricultural economy in the long-term and an abundant domestic food supply, Congress should structure a cap-and-

trade system that delivers an offsets program where the value exceeds the cost to farmers and ranchers.

We believe it is important to provide an initial list of project types that are considered eligible agricultural offsets. Both the regulated community and agricultural sector need assurances that agricultural offsets will be available. The regulated community should have confidence that a sufficient quantity of offsets will be available for purchase in order to comply with a mandatory cap. The agricultural sector also needs to have clear direction on project types Congress considers to be eligible in order to assess the full impact of cap-and-trade legislation on our industry. An initial, non-exhaustive list of project types in the legislation is critical to addressing these concerns. Shifting the burden of decision-making to an entity other than Congress generates uncertainty that should be avoided. The House version includes such a project list, and NCGA is generally supportive of these provisions even if some modification of the list is necessary in the Senate.

Another top priority of our industry under a cap-and-trade system includes the role of the U.S. Department of Agriculture (USDA). NCGA feels that USDA should play a prominent role in developing standards and administering the program for agricultural offsets. The Department has the institutional resources and technical expertise necessary to oversee a program that has the potential to be massive in scope. USDA has a proven record of working with farmers, in addition to studying, modeling and measuring conservation as well as production practices that sequester significant amounts of carbon. USDA should be given adequate flexibility to implement an offset program which allows them to account for new technologies and practices that emerge. This will in turn result in emission reductions from agricultural sources. NCGA is supportive of the respective roles for USDA and EPA as spelled out in the House version of the bill, which assigns all rulemaking and implementation authority to USDA and provides EPA with a limited administrative function in the program.

NCGA also believes that an important component of creating a successful cap-and-trade system is ensuring that domestic offsets are not artificially limited. H.R. 2454 calls for two billion tons of offsets, half of which are domestic. While the legislation establishes a fairly robust offset market, current estimates predict that agricultural and forestry lands can help to reduce at least 20% of greenhouse gas emissions in the U.S. on an annual basis. Therefore, we believe it is unwise and would distort the market if this one billion ton artificial cap on domestic offsets remains in the bill. The goal should be to remove as much greenhouse gas from the atmosphere as possible. Artificial caps could prevent legitimate carbon sequestration, livestock methane capture, and manure gasification projects from occurring.

Furthermore, NCGA feels that carbon sequestration and greenhouse gas mitigation rates should be based on sound science. There is a large body of scientific data which demonstrates that agricultural soils have the ability to sequester carbon, and technologies are available to effectively measure soil carbon content. In fact, the 2008 Farm Bill included a provision that directs the USDA to develop guidelines and protocols for farmers to participate in a greenhouse gas offsets market. USDA has begun developing a properly constructed, science based model that includes statistically relevant random field

measurements to help maximize agriculture's ability to participate in an offsets market. Any new policies should include provisions for the development of future offset standards and revision of existing standards to account for changing technology and information.

It is also important that USDA establish measurement rates for various offset practices at the national or regional level. NCGA believes in a standards-based approach rather than a project-based approach for measuring offsets. Real, verifiable credits can be achieved without direct measurement of each individual offset project; however, third-party auditing can be employed to ensure the credibility of the system. Meanwhile, a project-based approach would be cost-prohibitive, particularly for smaller farming operations and would prevent many producers from participating in the offsets market. We believe that an acceptable level of accuracy is achievable under a standards-based approach with pre-calculated values based on sound science. This should not preclude the development of new technologies or innovative practices that would require initial field testing or project measuring; however, even these new types of credits should eventually transition to standard protocols and values for ease of adoption.

Concerning the question of permanence, it is important to emphasize the concept of contract duration rather than a literal definition of "permanence." The value of the carbon credit would likely have a strong correlation to the length of the contract. For instance, longer contract periods imply more risk for the seller and should result in a higher price. H.R. 2454 allows for contract periods of five, ten and twenty years, which provide realistic, workable options for agricultural producers. Policies to address reversals, both intentional and unintentional, will also need to be established. Intentional reversals should be considered a breach of contract and the seller would be held responsible based on the terms of the contract. Unintentional reversals, such as instances of natural disasters or other unforeseen circumstances, could be handled through a reserve pool or perhaps a mechanism similar to crop insurance. The bottom line is that risk must be managed appropriately for both the offset buyer and seller, and in most cases, the emphasis should be placed on contract duration rather than permanence.

An issue that continues to be of utmost importance to NCGA is the treatment of early actors and additionality in a cap-and-trade system. The agriculture industry is constantly evolving. As technologies and practices improve, farmers are converting to alternative tillage practices such as no-till or ridge-till. They are reducing fertilizer application rates and enhancing crop uptake of fertilizer nutrients. Some livestock producers are able to use methane digesters and invest in covers for manure storage or treatment facilities while others are able to reduce enteric emissions with dietary modifications. Producers who have taken these steps should not be placed at a competitive disadvantage by being excluded from compensation for future offsets that occur as a result of these ongoing efforts. H.R. 2454 acknowledges this issue by allowing carbon credits for producers who initiated sequestration practices as early as 2001; however, NCGA does not believe this language is inclusive enough.

For example, some of our members have recently begun participated in the Chicago Climate Exchange (CCX) while others have been sequestering carbon through

conservation practices outside of a trading market for many years. These early actors should not be penalized for being pioneers in the area of no-till or low-till agriculture. Planting and tillage decisions are made each year, and there is no guarantee that a producer will decide to continue the same practice as the previous season. It is imprudent to eliminate these early actors from the offset market based on this flawed assumption. In fact, even continuous no-till farms, which represent a small percentage of all U.S. acreage, have the capacity to continue to sequester additional carbon for many years in a row. The bottom line is that each and every crop we grow sequesters additional carbon, and policies should recognize this fact. In addition, Congress should not establish policies that offer perverse incentives to producers that have heretofore been sequestering carbon in the soil. To that end, NCGA supports the development of an "avoided abandonment" offset credit so that no-till producers can receive compensation for their ongoing sequestration activities regardless of when that practice began. The treatment of early actors, particularly those who initiated their efforts prior to 2001, is one major deficiency in the House bill.

It is important to note that many practices undertaken to reduce greenhouse gas emissions will provide additional public benefits, such as clean water, wildlife habitat, and reduced soil erosion. Eligible projects in a greenhouse gas offset market should not be excluded from also participating in Farm Bill conservation programs other markets for environmental services that currently exist or may arise in the future. Allowing producers to "stack" credits will maximize the economic viability of carbon sequestration and manure management projects, ensuring more projects are undertaken and synergies with other environmental priorities are developed.

Lastly, the House passed version of H.R. 2454 also includes an important provision related to the Renewable Fuels Standards. The House bill prohibits EPA from considering indirect land use change when conducting their life cycle analysis for corn based ethanol until a peer reviewed study can be conducted to verify the scientific accuracy of the current modeling. NCGA has criticized recently published data that would suggest a direct correlation between domestic ethanol production and international deforestation. The language in the House bill is a step in the right direction towards sound science a more rational life cycle analysis. We would urge the Senate to include the same provision in its version of the climate bill.

In conclusion, it is our hope that we can continue to work with the Senate Agriculture Committee to ensure Congress chooses the best path for agriculture and rural America. Finally, corn growers will continue to meet the growing demands of food, feed and fuel in an economical and environmentally responsible manner.

I thank the Committee for its time and look forward to any questions you may have.

DOCUMENTS SUBMITTED FOR THE RECORD

SEPTEMBER 9, 2009

TESTIMONY OF C. ROSS HAMILTON, PH. D.

VICE PRESIDENT OF GOVERNMENT AFFAIRS AND TECHNOLOGY

DARLING INTERNATIONAL INC.

TO THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND
FORESTRY

September 15, 2009

Darling International Inc. (“Darling”)¹ would like to thank the U.S. Senate Committee on Agriculture, Nutrition and Forestry (“The Committee”) for the opportunity to submit written testimony to the Committee’s hearing entitled “Global Warming Legislation: Agricultural Producer Perspectives and Trading Regulation under a Cap and Trade System.” The rendering of animal byproducts and mortalities is an important carbon capture/greenhouse gas avoidance technology, the benefits of which may equal or exceed the environmental benefits derived from many other important agricultural and forestry practices, such as reduced or no-tillage farming and re-forestation. As with these other conservation practices, the use of rendering services for the disposal of animal byproducts and mortalities should be encouraged. Darling therefore, urges the Committee to recognize rendering and similar technologies that avoid greenhouse gas emissions by capturing and using carbon and nitrogen from waste products as eligible domestic agricultural and forestry offset practices.

¹ Darling is publicly traded, which limits information that can be disclosed. Industry data will be used instead where appropriate. Darling’s public filings and other information about the company are on its website www.darlingit.com.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

Description of Darling International Inc.

Darling, the largest and only publicly traded independent rendering company in the United States, is one of America's leading providers of rendering, recycling and recovery solutions to the nation's food industry. Rendering companies, such as Darling, collect the remains of animals that die outside of the food chain (i.e. on the farm) and materials that would otherwise be discarded, such as meat and slaughter byproducts and used cooking oil from the restaurant industry, and process these inedible wastes to make useable products such as animal fats, recycled cooking oil and animal proteins. These finished products are used as animal feed ingredients, by the oleo-chemical industry and to make biofuel, as previously described for Congress by the Congressional Research Service². Darling is a U.S. agricultural-based company that employs more than 1850 people to operate 83 registered facilities located in 24 states. This infrastructure is used to provide services in more than 33 states to approximately 116,000 farmers, ranchers, butcher shops, independent meat and poultry processors, grocery stores and food service establishments. In addition to its collection, blending and manufacturing facilities, Darling's headquarters are located in Irving, Texas. Darling recognizes its responsibilities in areas such as environmental protection, animal feed/pet food safety and animal health and has a long history of public policy engagement in these and other areas at the state and federal level. Darling includes reasonable solutions to regulatory problems when commenting on relevant rulemaking to regulatory agencies, such as the Food and Drug Administration (FDA), services within the United States Department of Agriculture (USDA), U.S. Environmental Protection Agency (EPA) and the California Air Resources Board (CARB).

Rendering services are essential to the sustainability of animal agriculture

Typically, the agricultural practices considered as eligible sources of offsets are agronomic practices such as changing cropping patterns, reduced tillage, forest/grassland conservation, reduced deforestation and others that sequester carbon in plants and/or the soil to delay the release of greenhouse gases. Without diminishing the importance of carbon sequestration, practices that prevent greenhouse gas production may provide a more permanent way to reduce climate change.

² CRS Report for Congress RS21771, Animal Rendering: Economics and Policy, 2004. This report was prepared for Congress after bovine spongiform encephalopathy (BSE) was detected in the U.S. Since CRS issued this report, fats from rendering have become more important as a biofuel and as a feedstock for biodiesel and renewable (green) diesel.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

Such greenhouse gas avoidance strategies considered in H.R. 2454 that are available to animal agriculture, include dietary modifications to reduce methane production in cattle and manure management to either reduce or capture methane for use as a fuel. Rendering is also an effective technology for capturing and recycling carbon and should be treated comparably to these other agricultural practices as the Committee develops its list of eligible offset practice types. Darling and other rendering companies are important agri-businesses that provide essential services to animal producers, as well as meat packers, meat processors, and others in the food industry. Without such services, it would be difficult for the animal production and meat industries to remain environmentally sustainable.

USDA estimated that in 2008 more than four million cattle and calves and nine million pigs died on farms or prior to slaughter³. Commercial and on-farm slaughter of cattle, pigs and lambs resulted in another 26 billion pounds of inedible animal byproducts.⁴ The poultry industry also generates large volumes of poultry mortalities and byproducts each year. Without rendering, animal producers and meat processors would have to find alternative methods for the disposal of their dead animal remains and animal byproducts. These are putrescible materials that will readily incubate diseases, pollute the environment and release greenhouse gases, if not properly handled. Only rendering can address all of these issues. Rendering is the most efficient and environmentally sound disposal alternative for the disposal of these animal remains. Despite its efficacy for greenhouse gas avoidance, however, rendering was omitted from the Agricultural and Forestry Related Offsets Title of H.R. 2454. Rendering and related practices that capture and recycle the carbon from animal, as well as, plant remains should be included as eligible offsets in this or a new Title.

Justification for rendering as an eligible offset practice or project

Title V, Subtitle A of H.R. 2454, covers the Offset Credit Program from domestic agriculture and forestry sources. Key terms, such as *offset credit*, *offset practice* and *offset project* are defined in §501 (a). Darling believes that the process of rendering should satisfy the definition for either an *offset practice* or an *offset project* and that the rendering of animal remains should satisfy the definition for *offset credits*. The carbon and nitrogen in animal remains is captured by

³ USDA National Agricultural Statistic Service, Meat Animal Production, Disposal and Income 2008 Summary.

⁴ USDA National Agricultural Statistic Service, Livestock Slaughter 2008 Summary. Total inedible byproducts calculated from red meat production and number of head and average weight at slaughter.

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

rendering and recycled into useable products, thus avoiding their conversion to carbon dioxide (CO₂), methane (CH₄) and nitrous oxide (N₂O) gases. Based on greenhouse gas production measured as animal remains decompose⁵, one metric ton of carbon dioxide equivalents (CO₂e), which should qualify for issuance of one offset credit, will be avoided for each 1,065 pounds of animal remains recycled by rendering. Recognition of the rendering process as an eligible offset practice or project would therefore, allow a farmer or a rendering company to receive one offset credit for trade or to use, whenever the remains of a mid-sized cow is rendered. This would ultimately benefit the farmer either directly when he trades the credit, or indirectly when a rendering company applies the value of the credit against the cost of rendering an animal's remains. The value of the benefit would depend on the market value of the credit under a federal cap and trade system.

Section 502 instructs the Secretary of Agriculture to establish a governance program to ensure that certain minimum standards are met in order to generate offset credits from domestic agriculture and forestry sources. Darling agrees that the Secretary of Agriculture should administer agricultural derived offsets under a federal cap and trade system. Darling also agrees that offset credits must be verifiable and issued only when activities result in permanent reductions of atmospheric greenhouse gases. Darling disagrees however, that offset credits can only represent additional greenhouse gas emission reductions for agriculture. This additionality requirement may be applicable for reducing greenhouse gases from combustion emissions, a major contributor to increasing levels of atmospheric greenhouse gases. Additionality may not be appropriate for agriculture which has traditionally used practices that reduce greenhouse gas emissions by either sequestering carbon (such as reduced tillage or converting crop land to grass) or capturing and recycling carbon (such as recycling of plant and animal byproducts). Therefore, additionality should be used judiciously and not broadly applied for agricultural offset practices, projects or credits. In contrast to methods for decreasing industrial combustion emissions, which may be accomplished by applying engineering solutions or using capital to upgrade facilities, agriculture is based on complex biological systems which may not respond predictably to new engineering or capital. Indeed, basing the eligibility of a practice on a calendar date will incentivize the adoption of new practices and discourage the use of established practices that may be more effective. The goal should be to obtain a measureable net reduction in atmospheric

⁵ S. Xu, X. Hao, K. Stanford, T. McAllister and F. Larney, "Greenhouse Gas Emissions during Co-Composting of Cattle Mortalities with Manure", *Nutrient Cycling in Agroecosystems*, Vol. 78, 2007, pp. 177-187.

greenhouse gas levels. This will not be achieved if the net result of replacing an established practice with a new one is an increase in greenhouse gas emissions. Such unintended consequences are illustrated in the following examples:

- *Scenario 1.* Converting land used for crop production to grassland might be an eligible practice if it was converted after January 1, 1999, but not if the grass was established prior to this date. A farmer interested in offset credits might be encouraged to convert a block of land seeded in grass prior to 1999 back to crop production. To gain the offset credit, the farmer may then either seed a new block of land to grass or seed grass on the original block after raising crops on it for a requisite period of time. In this scenario, the farmer might receive offset credits from a net increase in greenhouse gases emitted when the grassland was tilled, which released carbon sequestered in the plants and soil, and from the farm machinery used for tilling and reseeded.
- *Scenario 2.* Recycling practices in agriculture are particularly vulnerable to unintended consequences caused by additionality. Capturing methane in landfills and flaring it off or using it as a fuel will likely be an eligible offset practice. Animal and plant remains would be excellent sources of methane gas in a landfill. If the rendering of animal remains (or recycling plant remains) is not also an eligible offset practice, the value of offset credits may encourage the diversion of animal remains from rendering to landfills. In this scenario, the landfill would receive offset credits for capturing greenhouse gases which had been avoided by rendering before the material was diverted to the landfill. A net increase in greenhouse gas emissions would result from flaring the methane or burning it to make electricity.

In order to prevent such unintended consequences and to assure that offset credits are issued only for practices that can be verified to permanently and actually reduce atmospheric greenhouse gases, the Committee is urged to avoid making additionality a basic requirement for eligible agricultural and forestry practices.

In addition to giving the Secretary of Agriculture the authority to develop a list of domestic agriculture and forestry practices eligible to generate offset credits, §503 lists minimum practices

to be included. Neither rendering nor any other carbon capture/recycling practice is included as one of these minimum practice types. Darling encourages the Committee to recognize the greenhouse gas reduction potential of rendering and similar practices by including rendering in this list of minimum practices. Rendering may be included either directly as a named eligible carbon offset practice or through a general statement that acknowledges recycling efforts in agriculture and lists rendering as an example. Possible language the Committee may consider is: "Practices that capture and recycle carbon from agricultural materials to avoid greenhouse gas release into the atmosphere, such as rendering, shall be considered as eligible offset practices".

The Role of Rendering in Greenhouse Gas Avoidance

Each year, the U.S. rendering industry processes 60 billion pounds of animal mortalities and animal byproducts⁶. Unless stabilized by rendering or a comparable process, these materials decompose rapidly, with the rate being influenced by environmental conditions. Because animal remains consist primarily of water, carbon and nitrogen, greenhouse gases such as CO₂, methane and nitrous oxide are produced and released as the remains decompose. Essentially all of the carbon will be converted to CO₂ or methane, depending on the availability of oxygen during decomposition. If oxygen is readily available, as in properly composted material, CO₂ will be the primary gas produced. Limiting oxygen during decomposition, as may occur in a landfill, will shift gas production to favor more methane and less CO₂. Almost 5 million metric tons of carbon and 500,000 metric tons of nitrogen are captured annually by rendering.⁷ This amount of carbon is enough to form 17.5 million metric tons of CO₂. Rendering has a very positive carbon footprint⁸. A typical rendering plant captures and recycles more than seven times more CO₂e than it emits, when all emissions associated with collection, transportation and processing animal remains are considered. Based on greenhouse gas production measured when cattle remains were composted,⁹ composting all of the material that is rendered in the U.S. each year would release 39 million metric tons of CO₂e. Placing these same materials into landfills could result in 120 million metric tons of CO₂e being produced each year, assuming landfill gas is 50% methane and 50% CO₂.¹⁰ Burial of carcasses is restricted or prohibited in many areas of the U.S. due to the potential for

⁶ National Renderers Association website www.nationalrenderers.org.

⁷ National Renderers Association Issue Paper, "Rendering and Its Role in Capturing Carbon Emissions," June 2009.

⁸ National Renderers Association, <http://nationalrenderers.org/environmental>

⁹ Xu, loc. cit.

¹⁰ EPA Office of Air and Radiation, "Frequently Asked Questions About Landfill Gas and How It Affects Public Health, Safety and the Environment", June, 2008.

ground and surface water contamination. When animal remains are buried however, greenhouse gases, such as CO₂ and methane, are produced as the remains decompose underground.¹¹ These gases will escape into the atmosphere if the site is disturbed or gas pressure builds as gases accumulate (as in multiple carcasses in the same burial site) until the gases erupt through the surface.

Facilities that concentrate cattle in large numbers on a single site, such as dairies and feedlots are the most dependent on rendering because of carcass disposal and animal health concerns. A 2005 rendering industry study concluded that 45% of the remains of all cattle that die prior to slaughter in the U.S. each year are rendered.¹² Rendering the remains of all of these cattle avoids the production of more than one million metric tons of CO₂e per year. Emissions from rendering a 1400 pound cow will total approximately 0.09 metric tons of CO₂e, but the formation of 1.32 metric tons of CO₂e will be avoided, resulting in a net greenhouse gas avoidance of 1.23 metric tons of CO₂e.¹³ Rendering is also important to other sectors of animal production, such as pork production. The remains of 67% of all pigs that die prior to slaughter in the U.S. are rendered, based on results of another industry study.¹⁴

Changes the FDA has recently made to its regulations for animal feed and pet food could decrease the number of cattle mortalities that are rendered from 2005 levels. On April 26, 2009, FDA strengthened existing feed safeguards that were put in place in 1997 (21 CFR §589.2000) to prevent the spread of bovine spongiform encephalopathy (BSE; "Mad Cow Disease") among cattle and other ruminant animals in the U.S. Enforcement of these new regulations (21 CFR §589.2000 and 2001) will begin on October 26, 2009 and prohibit the inclusion of brain and spinal cord from cattle 30 months of age or older in feed or food for any animal. These tissues were already prohibited, along with others, from human food, so the rule will have a small impact on the rendering of waste materials from cattle inspected by inspectors from USDA's Food Safety and Inspection Service (FSIS) or state meat inspection services and passed for use in human food. However, for cattle not inspected and passed, such as cattle that die prior to slaughter, the entire carcass will be considered to be prohibited for use in any animal feed, if the brain and spinal cord

¹¹ A. Nutsch and M. Spire, "Burial", in *Carcass Disposal: A Comprehensive Review*, ed. by National Animal Biosecurity Consortium, August 2004, pp 43-44.

¹² Informa Economics, "Economic Impacts of Proposed Changes to Livestock Feed Regulations", December 2005.

¹³ Based on carbon footprint determinations by Darling International Inc. for rendering facilities and greenhouse gas production during composting by Xu, loc. cit.

¹⁴ Sparks Companies Inc., "Livestock Mortalities: Methods of Disposal and Their potential Costs", March 2002.

are not removed prior to rendering. Removal of the brain and spinal cord from the remains of dead cattle will be labor intensive for renderers because rendering facilities are not designed to handle cattle carcasses the same way that beef packers do. In addition, soft tissues such as the brain and spinal cord decompose rapidly, especially during the summer, which makes them difficult to remove effectively during certain seasons or if the remains are not received by the renderer soon after death. These decomposition issues combined with the higher labor and disposal costs renderers will incur in order to comply with the new feed regulations are expected to reduce the number of cattle mortalities that will be rendered under the new feed regulations. The rendering industry estimates FDA's new feed regulations will decrease the number of cattle mortalities rendered by 66.7%¹⁵.

The proportion (55%) of cattle that die in the U.S., but are not rendered today, may contribute approximately 1.5 million metric tons of CO_2e per year to the atmosphere (assuming gas produced during decomposition is similar to rates observed for composting¹⁶). The anticipated diversion of cattle mortalities away from rendering and to other disposal options under the new FDA feed regulations, may further increase greenhouse gas production to 2.2 million metric tons of CO_2e per year. In addition, diverting animal remains away from rendering can damage the environment in other ways, such as contributing to nitrogen and phosphorus loading of soil and surface/ground water as well as threaten animal and human health.

The primary economic value for animal protein meals is as a feed ingredient. If the remains of dead cattle that are 30 months of age and older are rendered without first removing the brain and spinal cord, the animal protein meal that is produced will be prohibited for use in the feed or food of any animal by the FDA, under its new feed regulations. Furthermore, renderers must keep these prohibited materials separate from material that is free of the prohibited material. Therefore, in order to render cattle remains without removing the brain and spinal cord, the renderer would have to charge the farmer enough to recover the value of the protein meal that must be disposed of because it cannot be sold for use in feed. Most cattle producers will not pay these additional charges, which is why renderers have been unable to justify dedicating a separate processing line or facility for use as a disposal rendering operation. Including rendering as an eligible agricultural offset practice so that the rendering of cattle remains could qualify for offset

¹⁵ Informa Economics, *loc. cit.*

¹⁶ Xu, *loc. cit.*

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

credits may make disposal rendering feasible (depending on the value of the offset credit) and encourage rendering as a means for disposing of all cattle remains. Encouraging the use of rendering as a disposal method would reduce emissions of greenhouse gases, as well as reduce the release of infectious bacteria and viruses and other potentially harmful agents into the environment. Cattle producers potentially benefit because either they would receive carbon offsets that can be traded to pay the additional service fees renderers will charge for disposal rendering or renderers may not have to raise their service fees.

Even if additionality remains as a basic requirement for agricultural offset practices, rendering should still be an eligible offset practice. It has already been pointed out that 55% of the cattle and 33% of the pigs that die in the U.S. each year are not being rendered today. With the new FDA feed regulations pending in a few weeks, this number will likely increase. Under a federal cap and trade system, rendering the remains of approximately 75% of the cattle that die each year should be eligible for offset credits. Incenting farmers to dispose of their animal remains through rendering would have a measurable impact on reducing greenhouse gas emissions. Renderers would also be encouraged to dedicate processing lines or facilities for disposal processing.

The relative importance of the greenhouse gas avoidance potential of rendering to agriculture can be made by comparing it to the carbon sequestration potential of land enrolled in the Conservation Reserve Program (CRP). Land in the CRP has already been considered eligible as a carbon offset for trade on the Chicago Climate Exchange. The CRP is administered by the Farm Service Agency of the USDA. According to USDA, there are approximately 35 million acres of land previously used for crop production that have been seeded in grass, shrubs and trees and are currently enrolled in the CRP¹⁷. Some aggregators validating carbon credits for trading on the Chicago Climate Exchange have offered up to 0.75 metric tons of carbon credits per acre¹⁸. If this rate is applied to all CRP enrolled acres, it would represent approximately 26 million metric tons of CO₂e as being sequestered per year. Although it is important for agriculture to consider both CRP and rendering as important greenhouse gas reduction strategies, rendering currently avoids the production of 1.7 times more greenhouse gases than CRP, when the annual impact of

¹⁷ USDA, "USDA Issues \$1.8 Billion in Conservation Reserve Program Rental Payments" News Release, October 1, 2008, Release No. 0251.08

¹⁸ Nebraska Farmers Union, "Nebraska Farmers Union Announces Carbon Credit Program for All Nebraska Counties & New Rangeland Management Program," April 19, 2007, News Letter. (<http://nebraskafarmersunion.org>).

Darling International Inc. Comments to U.S. Senate Committee on Agriculture, Nutrition and Forestry

CRP is compared to the greenhouse gases avoided (39 million metric tons of CO_2e) when material is rendered as opposed to composting.

Verifying the amounts of carbon and nitrogen captured for recycling can be easily documented. Darling already possesses much of the information necessary to verify the carbon and nitrogen content of the materials it recycles as well as records needed to identify farmers, ranchers, meat processors and others that send animal remains to Darling for rendering. The chemical composition of the animal protein meals and animal fats derived from rendering is easily done using validated procedures. Darling routinely collects samples of all of its finished products to monitor product composition. In addition, all of Darling's recycling facilities are individually registered with the FDA pursuant to § 415 of the Federal Food, Drug and Cosmetic Act and 21 CFR Part 1, Subpart H. All Darling rendering facilities are also registered with FSIS/USDA as required under 9 CFR § 320.5. Darling also complies with FDA regulations (21 CFR §589.2000 and 2001; 21 CFR Part 1, Subpart J; Section 417 of the Food, Drug and Cosmetic Act) that require that records be kept of all incoming materials for processing, including the name and address of the source and weight of the material and all outbound materials, including the name and address of the buyer/consignee and weight of the material. Such records are to facilitate traceability one-step backward and one-step forward in the supply chain.

Conclusion

Rendering is an effective method for collecting, processing and recycling the remains of dead animals and meat processing wastes. These materials are highly putrescible and release greenhouse gases as they decompose. Designating rendering as an eligible offset practice in climate change legislation approved by the Senate will promote the responsible disposal of these animal remains and avoid unnecessary CO_2 , methane and nitrous oxide emissions. Including rendering as an eligible offset practice will provide an important measureable offset to the agricultural community.



Senate Agriculture Committee Written Testimony
Global Warming Legislation: Carbon Markets and
Producer Groups

September 16, 2009

Senate Agriculture Committee Testimony
September 16, 2009
National Milk Producers Federation

Mr. Chairman, Ranking Member and members of the committee: thank you for the opportunity to submit agriculture's views on climate change legislation. My name is Jerry Kozak and I am the President/CEO for the National Milk Producers Federation (NMPF). NMPF develops and carries out policies that advance the well being of dairy producers and the cooperatives they own. The members of NMPF's 31 cooperatives produce the majority of the U.S. milk supply, making NMPF the voice of more than 40,000 dairy producers on Capitol Hill and with government agencies.

The House of Representatives passed H.R. 2454, our organization appreciates the fact that the bill's authors did not regulate agriculture under the cap-and-trade system they propose in the bill. NMPF supports the concept of cap-and-trade as long as agriculture is not a capped industry. However, NMPF remained neutral on the overall bill passage because it is still unclear what impact will be felt on the dairy industry. This is why it is critical that before this bill becomes law, Congress must address a number of concerns. My testimony today will focus on the specific context of offsets and allowances from which we view this bill and climate change policies overall and the changes we would like to see the Senate correct starting from H.R. 2454.

The Dairy Farm Economic Crisis

It has been a very difficult year for dairy farmers. And we have greatly appreciated all of your help and support as farm level milk prices headed sharply lower creating tremendous economic stress and pressures in the dairy farming community. The price that farmers were receiving for bottled milk was down nearly 50% from last winter. Current prices received by farmers do not even cover the cost of feed. The reason farm prices have declined so drastically is due to the slowdown in the US and global economy with the end result of a precipitously drop in U.S. exports. The problems in the global economy and the effects on consumers' buying habits are adding to that downward pressure.

Dairy Farmer's GHG Commitment

Despite these severe economic challenges, dairy farmers and their cooperatives have maintained their deep commitment to reducing their GHG emissions on farm and throughout the dairy chain. Our industry has voluntarily committed to an action plan to reduce the carbon footprint of fluid milk by an additional 25% by 2020. Work is underway throughout the dairy industry to help achieve this goal. We are looking at

farm practices ranging from dairy feed systems, efforts to reduce enteric methane production, to farm energy audits, and addressing barriers to methane digesters. At the processing level, practices being examined include items like non-thermal UV technology as an alternative to heat-based pasteurization, increased energy efficiencies in dairy plants, improved transportation systems, as well as product packaging and delivery systems.

One of the primary challenges standing in the way of wider adoption of these opportunities is the significant cost entailed. We are hopeful that an offsets market could make many of these GHG reduction practices and processes more affordable and widespread in our industry.

Dairy Sector's Strong GHG Performance Historically and Today

There have been inaccurate perceptions that animal agriculture is a significant contributor to U.S. greenhouse gas emissions. In fact, the modern dairy sector has improved its performance on GHG emissions dramatically over the last 60 years and any effort to return to the production systems that prevailed in the 1940s would have a disastrous effect on our industry's GHG performance.

EPA has reported that animal agriculture is responsible for approximately 2.5% of US GHG emissions, about half of which is enteric fermentation (1.7% of total).¹ As these statistics show, modern US livestock agriculture is a very small portion of US emissions. Manure methane and nitrous oxide emissions from dairy cows, as reported in the EPA Inventory, are only about 0.3% of total US emissions of all GHGs on a CO₂ equivalent basis. The emissions from all livestock are only about 0.8%.²

Research conducted recently at Cornell University and published in the Journal of Animal Science explores these questions and finds that the most efficient and environmentally friendly way to raise dairy cows and produce milk is definitely not the use of the dairy farm systems that prevailed before the advent of modern commercial farming. The article, entitled "The environmental impact of dairy production: 1944 compared to 2007," found that:

Modern dairy practices require considerably fewer resources than dairying in 1944 with 21% of animals, 23% of feedstuffs, 35% of the water, and only 10% of the land required to produce the same 1 billion kg of milk. Waste outputs were similarly reduced, with modern dairy systems producing 24% of the manure, 43% of CH₄, and 56% of N₂O per billion kg of milk compared with equivalent

¹ Environmental Protection Agency (EPA), 2008. "Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990-2006. EPA, Washington, DC. Calculated from statistics provided in tables ES-2 and 6-1.

² The other .2% of emissions associated with livestock production comes from nitrous oxide.

milk from historical dairying. The carbon footprint per billion kilograms of milk produced in 2007 was 37% of equivalent milk production in 1944.”

Not surprisingly, the dairy sector's total carbon footprint has also been dramatically reduced. Total GHG emissions for the dairy sector in 1944 was 194 million metric tons in CO2 equivalents. By 2007 this had been reduced by 41%, to 114 million metric tons. The article closes with, “Contrary to the negative image often associated with ‘factory farms,’ fulfilling the requirement for dairy products of the US population while improving environmental stewardship can only be achieved by using modern agriculture techniques.” Modern US dairy farming is a tremendous example of how the world can produce the goods and services needed by people, in this case the very food we eat, and doing so while producing less GHGs per calorie of food.

Dairy producers and the entire dairy chain are committed to meeting these goals. It is from our dairy sector's commitment to continuing this record of GHG performance while helping feed the US and the world and helping our businesses thrive that we offer the following comments on H.R. 2454.

1. **The bill must maintain a strong role for USDA.** H.R. 2454 recognized the importance of USDA to establish, audit and implement all the offsets standards and protocols for the agricultural offsets program. USDA has the technical understanding of the various practices that can generate offsets and has done research on how to measure GHG reductions or sequestrations coming from these practices. USDA also has the relationships with ranchers and farmers to facilitate the implementation of the program. USDA has the infrastructure to manage such a program – with county extension offices across much of the country. We understand that there is a necessary role for EPA to play in overseeing the environmental integrity of the offsets program, and feel that EPA and USDA should work jointly together to ensure that the agricultural offsets assist in the overall goal of the climate change program.

USDA is best positioned to create technical standards and protocols for GHG emissions reductions and sequestration from the agricultural and forestry sectors. Nearly all of the scientific data and documentation behind existing agricultural and forestry standards used by carbon registries is grounded in work conducted by USDA scientists or their land grant university partners. Thirteen of USDA's Forest Service scientists shared in the Nobel Peace prize for the UN Intergovernmental Panel on Climate Change report connected to their forestry work. USDA's Natural Resource Conservation Service, Cooperative State Research, Education, Farm Service Agency and Extension

Service, Economic Research Service and Agricultural Research Service have done similar work for agricultural practices that reduce GHG emissions and sequester carbon, such as methane capture and conservation tillage. USDA also has the institutional resources, administrative structure, and established relationships in place to engage farmers and ranchers across the country. USDA has tens of thousands of employees working with agricultural producers on various conservation issues. The relationships that USDA has with farmers and ranchers allow it to have the trust necessary to create, administer as well as drive higher levels of participation in the offset program. Indeed, their field assets, technical expertise and the level of trust that USDA has developed make it uniquely positioned. For these reasons § 2709 of the 2008 Farm Bill gave USDA the authority to create technical standards to facilitate participation in emerging carbon, water or other ecosystem service markets.

Since EPA will be charged with administering the overarching cap-and-trade system, we would expect EPA to review the integrity of the offset program. In that regard, EPA can periodically review the standards, protocols and verifications systems established by USDA to ensure that they are being successfully implemented into the larger cap and trade system.

2. **The bill's requirement for additional "performance standards" must be clarified so that CAFOs are not included in "back-door" climate regulation.** Section 811 of H.R. 2454 tasks EPA to set standards for regulatory compliance measures that would be required of some uncapped sectors. The criteria listed for this section could include some of the larger CAFOs in the livestock industry and would therefore remove these operations from being able to provide offsets and would instead require measures such as digesters to reduce their emissions as part of the performance standard for their category. While enteric emissions from animals are not counted, nothing is mentioned about methane or nitrous oxide emissions from manure or from combustion processes. It needs to be made clear that emissions from all agricultural and livestock activities are not regulated – either directly by the climate emissions cap, or indirectly by the performance standards. This clarity would reflect the promises that lawmakers sponsoring all climate change bills have long made to the agriculture industry that the sector shall not be regulated.

Methane digesters are a tested and proven technology however, the costs for installation, maintenance with limited return, prohibit many farms from

taking the leap to install them. Cost could range from \$2 to \$5 million to install a digester on a dairy farm. Through a cap-and-trade market, more farms will install digesters because it will become economically viable for additional producers to take the next step. However, if all producers were required to install methane digesters with no economic compensation through these performance standards, it would drive a significant number of them out of business.

The potential problem for the livestock industry comes if they are determined to have emitted at least 10% of the uncapped methane emissions in 2005 and/or were deemed to be responsible for emitting at least 20% annually of the uncapped GHG emissions. These triggers could mean that performance standards which are not detailed in the House passed version, could be applied to the livestock industry. Even if regulations are not imposed, if the 10,000 ton emission level is met, GHG reporting would likely be required.

Another area of concern comes from the fact that the performance standards themselves remain unknown. That is, this section requires the EPA administrator to come up with regulations, but does not specify exactly what will result from this process – leaving a big unknown for the industry and an unintended situation.

3. **The bill should shorten the time allowed for setting up offsets program standards.** Section 732(a) of the Waxman-Markey bill creates an offset program via regulation “Not later than 2 years after the date of enactment of this title”. As written, it is probable that regulations establishing an offset program will not be in place when the cap-and-trade system takes effect. Having regulations in place early will allow the necessary infrastructure to develop to establish a carbon market that can complete transactions and trades. Agricultural and forestry offset projects are currently being created across the country and in other countries under voluntary private and State or regional carbon markets. The Clean Development Mechanism (CDM) in the Kyoto Protocol, the Chicago Climate Exchange (CCX), the Regional Greenhouse Gas Initiative (RGGI), and California’s Climate Action Review Board (CARB) all are examples of systems with existing carbon protocols and markets, providing ample precedent from which a federal program can be crafted. Further, under the 2008 Farm Bill USDA has been charged with establishing protocols for carbon and other ecosystem service markets. The government of Canada is establishing a carbon offset program (to include
-

agricultural and forestry offsets) in 2010, and the carbon trading program in 2012, to ensure the availability of offsets at the start of the system.

4. **The bill must recognize and reward the avoided emissions efforts undertaken by agricultural leaders to reduce GHG emissions and/or sequester carbon.** Significant numbers of agricultural and forestry landowners have already undertaken actions that reduce GHG emissions or sequester carbon. These early actors should be eligible for compensation for the avoided emissions. The reason this is so important is because the greenhouse gas reductions and sequestration performed by early actors is not required by law and can be undone if the current bill's perverse incentive is not corrected. In order to maintain these avoided emissions – or emissions that could otherwise be emitted, there must be compensation. The House bill has a very limited recognition of early actors and the Senate bill should correct this issue.

Congress must recognize and reward the early efforts undertaken by agricultural leaders to reduce GHG emissions and/or sequester carbon. Significant numbers of agricultural and forestry landowners have already undertaken actions that reduce GHG emissions or sequester carbon. Changes in management taken by these early actors include, but are not limited to, switching to or maintaining zero tillage ("no-till"), using new technology to capture methane for improved animal waste management, and afforesting or reforesting buffers or larger ecosystem landscapes. These early actors should be eligible for compensation for the on-going GHG emissions reductions or carbon sequestration that they achieve within the offset program, if they qualify under all other offset protocols

The treatment of early actors is vital to agriculture's participation in a climate change system. Producers across the American landscape have been engaged in innovative efforts to sequester carbon using a variety of techniques. These producers should be allowed to participate in the offset program being created by Congress under a cap-and-trade regime. The central purpose of any offset program is to encourage the widespread adoption of conservation or other practices that reduce GHG emissions or sequester carbon and which in turn reduces, and potentially reverses global warming impacts, as well as provides cost containment for the entire cap-and-trade system. Agricultural producers who have already begun to experiment with GHG emissions reductions and carbon sequestration

practices, techniques and projects are critical emissaries to promote and ensure widespread adoption of these practices. In fact, these early actors often are the leaders of agricultural organizations and their leadership is needed to constructively engage their organizations and their membership on climate change policy. Thus, by rewarding early actors we support constructive political engagement by agriculture and we create a core group of emissaries who will encourage offset projects.

Allowing early actors' projects to be eligible does NOT automatically result in offset credits being issued for previous reduction activities. Early actor projects, like any other project, would have to comply with all other offset protocols for the practice, technique or project type that they are engaged in. Thus even if a producer adopted a practice in 2002, if that producer does not meet other offset protocols he will not be eligible to provide offset credits. Further, early actors will not be paid for GHG emissions reductions or carbon sequestered retroactively. Instead, they will be paid for future GHG emissions reductions or carbon sequestration. As an example, if a producer began no till in 2002 and his soil is projected to reach saturation in 25 years then that producer will only be paid for carbon sequestered between the date any cap-and-trade system starts and 2027.

5. **The agricultural sector should be provided with an allocation of allowances, or a portion of allowance auction revenues.** While climate change legislation will impose higher input costs (such as fuel and fertilizer) for agriculture as a sector, producers have an extremely limited ability to pass higher costs along to downstream purchasers. Agricultural producers are typically price takers in economic terms and in such a situation an allowance allocation, or the proceeds of an allowance auction, could serve to smooth the transition for producers, especially those that are not in a position to capture potential offset credit benefits. Small producers for example are less likely to be in a position to generate offset credits—it may be a simple matter of the amount of credits that they could generate not warranting the cost of changing the practice or the cost of compliance to verify the offset credits themselves. Allowance set asides, or the proceeds from an allowance auction, should be used by USDA to smooth the transition for at-risk agricultural producers as we establish a new carbon reduction system.

The agricultural sector faces unique challenges in dealing with the impacts of climate change as it begins to impact our nation and world. Agricultural producers experience and are impacted by climate and weather changes

perhaps more than any other sector; for most farmers and ranchers changes in moisture, temperature, and alterations in the growing season directly impact the ability to produce the food and fiber our nation and world need. As such, allocating allowances or allowance revenues for research into adaptation is vital. New seeds, new technologies and new techniques will be needed for the farmer and rancher of the future to produce the same vast quantities of food that we enjoy today. As global populations continue to expand, the American producer will be called upon to produce even more, and government aided research efforts into adaptation can help achieve that objective.

Farmers and ranchers are creative and innovative. As carbon markets develop, new techniques, practices and technologies for reducing GHG emissions and for sequestering carbon will be developed, yet funding could be vital to bridge the development phase for producers. Allowance allocations, or the proceeds of an allowance auction, could serve to encourage the development of these yet to be discovered carbon sequestration or emissions reduction methods—allowances could in effect serve as a bridge as data is collected and verified. Eventually, after an appropriate developmental phase, some of these techniques could be certified as accredited offsets, and thus would no longer require allowance funding.

6. **Offset eligibility and compensation should be based on whether a project, technique, or practice sequesters carbon, or otherwise reduces greenhouse gases (GHG) from a date certain.** Use of the BAU methodology in the Waxman/Markey bill will limit the amount of GHG emissions reductions or carbon sequestration by agriculture and forestry. The central purpose of the legislation is to reduce or eliminate as much CO₂ as possible, yet by using a BAU methodology to determine project eligibility limits the amount of low cost offsets that will be provided. Section 734(a)(1) requires that offset projects conform to a standard methodology that will determine whether the offset project is BAU for an industry. The text further provides that the government can change baselines, perhaps significantly, on a regular basis. This unnecessarily creates a high level of uncertainty for agricultural producers and investors regarding whether offset projects they are undertaking or about to undertake will qualify for offset credits. Uncertainty in turn will dampen the level and scale of participation in an offset program, and hence the success of the offset program, which is an important component of cost-containment in a cap-and-trade system.
-

By applying this type of updated BAU test for additionality the draft also ensures that the “hardest” or least likely projects or producers (i.e., those least likely to participate at modest prices and early stages of a program) will never participate. Rather than actively ignoring or omitting the “hardest” projects/least environmentally sensitive producers, an offset program should specifically strive to reach this population. Further, the logic of this type of BAU methodology devalues carbon emission reductions overtime. Projects that produce real, verifiable GHG reductions should receive credit.

To give one example: currently there are approximately 125 methane digester systems across the country, accounting for less than 1% of all dairy, hog, and beef cattle operations. Congress should enact a statute that incentivizes the installation of more digesters – striving for 100% penetration, for instance -- rather than deciding that at 50% market penetration the practice is considered BAU and will no longer receive offset credits. Thus digesters installed when market penetration is at 45% are just as valuable to GHG impacts as digesters installed at 95% market penetration (and perhaps more so, if early reductions have already been achieved, and we are seeking the latter, “harder” reductions); each of these digesters should receive just compensation for the emissions reductions delivered—actual tons of GHG destroyed—and not be dependent on when they were built in relation to each other.

The Waxman/Markey bill changes baselines over time unfairly moving the goal posts and limiting project investments. Rather than recurrently changing baselines as established in the bill, producers and investors need a static baseline to make production and investment decisions. USDA should be charged with determining the normal activity baseline for each offset project type using a historical or temporal baseline. Once USDA sets that baseline, offset projects can be judged against the baseline to determine whether a proposed action is additional vis-à-vis the temporal baseline. Such a baseline system will ensure certainty to producers (offset providers) and buyers.

7. **Global Implementation of Climate Change Legislation.** It is critical that the United States negotiates quickly a comprehensive implementation of GHG reductions around the world. Although we support the concept of cap-and-trade we remain concerned about the potential costs to the economy from unilateral action by the United States. There are a number of important agricultural exporters around the world that could gain competitive advantage if careful consideration is not given to the application of these reductions throughout the world.
-

These are the dairy industry's top recommendations for fully realizing the ag offset potential in the climate change legislation. We urge this committee to take on the role of champion for the agriculture industry in this matter as it has so often in other ag-related legislation. Our industry is concerned that should this bill pass through the Senate without these important corrections, there will not be a workable offsets title for America's livestock and farming sectors.

We cannot emphasize enough how important it is for this committee to make their stamp on the legislation that will come out of the Senate Environment and Public Works Committee. There are some who would advise standing on the sidelines and opposing this effort entirely. We believe that this is a huge risk for the livestock and row crop producers of America and we see great opportunities for our industry with properly crated legislation.

We urge this committee to proactively engage in drafting the Senate version of climate change bill better for agriculture.



QUESTIONS AND ANSWERS

SEPTEMBER 9, 2009

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Andy Beckstoffer
 September 9, 2009

Chairman Tom Harkin

You mentioned this briefly in your written testimony, but I want to spend a little bit more time discussing the impact that climate change is already having on your crops. I think this is an important topic to address because it illustrates the fact that there is a cost to doing nothing when it comes to climate change. For example, you mentioned more heat spikes, higher nighttime temperatures, and new pests and diseases as challenges that are beginning to emerge for your industry.

Even if we do not yet fully understand how all of these things will impact your business as a winegrape grower, surely these are challenges that concern you.

1. As a winegrape producer with over 30 years of experience in agriculture, could you talk a bit more about the business risks that climate change presents to your operation now and in the future?

On page five of my testimony I discuss more frequent heat spikes to which we have adjusted by installing trellises that we can alter on short notice to deal with heat spikes. We can adapt with proper viticultural practices at considerable expense, but it is necessary to maintain the quality of our premium winegrapes. There have been limited studies to assist the wine community in understanding the potential impacts of climate change to the quality and productivity of winegrape vineyards. However, the data we collect from vintage to vintage shows that we can adapt and that the maximum temperatures haven't changed so much – but that the minimum temperatures have risen, and that is something for which we must continually make adjustment. It is the extreme heat incidents and temperature changes, not the averages, that represent the most risk.

There is no doubt in my mind that much more needs to be done to identify suitable rootstocks and conduct new rootstock breeding programs to facilitate our adaptation. Of course, that is a years long – if not decades long – process and one that must be conducted in the context of changing consumer taste profiles and expectations. There is a five-year delay from the time I plant a vineyard to the time it reaches the consumer in a bottle. North Coast development costs for a new vineyard run from \$25,000 to \$40,000. Our capital investment is made for at least a 25 year period. That is why we invest so heavily in cutting-edge viticultural practices to adapt to things like changing temperatures.

Irrigation is critical to adaptation. The lower snow pack forecast by the experts and changing rainfall patterns present a very real risk to our businesses. Our quality, our productivity, and our profitability are dependent upon adequate water which we manage precisely with the most advanced technology in plant monitoring and water application.

The California Sustainable Winegrowing Program is an integrated whole farm approach to decision making that helps participants better understand and evaluate the trade-offs and impacts of each practice. It is an important tool for helping us adapt to changing resource and regulatory concerns.

The uncertainties presented by climate change and the scarce allocation of resources like water underscore the most important investment government can make: funding agricultural research and extension to assure that farmers and ranchers have the ability to continue adapting to meet the food and fiber needs of the world's rapidly expanding population.

2. Do you have any suggestions on how we could better educate farmers in other parts of the country about the implications to their livelihoods if nothing is done to address climate change over the decades to come?

Senator, this is surely not my area of expertise! However, the Committee might consider conducting field hearings in different regions of the country. It should also conduct hearings for researchers and extension personnel to provide information about the potential impacts of climate change to farmer and rancher livelihoods.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

While considerable research and demonstration of the advantages of no-till and minimum tillage practices has been done, not nearly enough research has been done to quantify the benefits of other practices and document their value as measurable, verifiable carbon and GHG offsets. Just a few of the ag practices that have the potential to produce significant offsets include cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

This is why it is critical that USDA with its technical and scientific expertise of agricultural and farming practices have the primary role in developing a GHG reduction or sequestration parameters for carbon offset protocols.

We plant our vineyards for an economic life of 20 years. Unless we are given credit for past and ongoing carbon sequestration, this legislation is of very little value to winegrape growers.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Farmers and ranchers must not be put at a competitive disadvantage in international trade. California winegrape growers face vigorous competition from other wine producing countries with lower costs of production.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

Those practices for which research has already been completed and protocols approved are planting trees (forestry) and conservation tillage. Therefore they are best positioned for measurable and verifiable offset credits. There is great potential for other ag practices to produce significant offsets and other environmental benefits from cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

It is very important that winegrapes and other perennial crops be given credit for carbon sequestration of past and continuing practices. We plant our vineyards for an economic life of 20 years. Thus, if credit is given only for new plantings, the legislation would be of little help to winegrape growers.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Domestic offsets should not be capped.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Luke Brubaker
September 9, 2009

Chairman Tom Harkin

In your testimony you mentioned being able to sell carbon credits for reducing greenhouse gas emissions through the use of your digester.

1) Can you tell us more about the economics of that project, please?

a. What was the total project cost and what is the annual income.

- Total project cost was \$1.25 million dollars.
- This year's income will be approximately \$200,000.00 for the sale of electric.

We derive a savings of approximately \$40,000 as a result of not needing to buy bedding for the cows. We separate the solids from the liquid and use it to bed the cows instead of buying wood shavings or saw dust.

We sell separated solids to other farmers. \$10,000 was derived from the sale of solids.

Sale of credits sold: about one-half sold for 20 years. What we sold equals over \$100,000 which when invested for 20 years approximately doubles the money.

b. How many credits does your system generate, how do you sell the credits, and at what price?

- KW = tons of carbon to sell taken out of the air.
- Sold to a trading company.
- The market fluctuates.
- We sold at a good time--\$3.00 to \$4.00 a ton.
- I believe the market is a lot less now.

- c. How does the income from the credits compare with the income from selling the electricity?
- A lot less for the safe of credits than sale of electricity.
 - With a good cap and trade bill, it could mean a lot more money for the credits.

Senator Pat Roberts

- 1) How many head of cattle does it take to make a methane/manure digester functional and economical?
 - A good number would be 500 head or more.
- 2) What is the annual operation and maintenance cost for a methane digester?
 - \$10,000 to \$25,000; this depends on the amount of repairs.
- 3) Does the functionality of a digester change with head count, feed content, or seasonal change? If so, how does this affect normal day to day operations and management ability?
 - Yes. In the summer, if there is more water in the manure, because of cooling the cows, it takes more volume of manure to make the same amount of electricity.
 - Adding other food products make extra electricity.
 - A little more setup on the computer system to add other feed or food by-products.
- 4) Do you believe a digester would work on a cow-calf operation, feeder cattle operation or for a small feedlot?
 - If the manure is in a liquid form that the manure can flow, it could work.
 - Getting the manure to the digester as quickly as possible is the key before it loses the gases into the air.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
 - I believe agriculture has a great opportunity with the use of conservation practices: no-till, cover crops, and methane digesters.
 - The bill must more than offset any higher cost the farmer would incur.
 - I do believe planting trees and forest management would be a big part of the program, but I am not sure if would benefit most of agriculture.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.
 - I think your statement is very true.
 - If a bill is written wrong, it would be devastating to agriculture.
 - Imports may have a tendency to come into the country like fertilizer, dairy products and fruits, etc. if U.S. products are priced out of the market.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
- In order: Planting trees, grasslands, no-till, cover crops, and methane digesters.
- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

- My farming operation put forth a significant capital investment in order to install the methane digester, which is a clean, efficient and an American source of renewable energy. I do not think it would be a good idea to cap domestic agricultural off-sets as proposed in the U.S. House version of the Climate Change legislation. There does not seem to be any sound policy rationale for placing a cap on such offsets, like those produced by my farming operation, that supply clean and efficient domestic energy and provide a valuable environmental benefit.

There may, however, be appropriate reasons for considering caps on international offsets for two reasons. First, many people argue that this legislation would drive American jobs off-shore. Without a cap on foreign off-sets, the purchase of such off-sets may also be driven off-shore, where there is little regulation and these off-sets would be feasibly cheaper than the same type of off-sets in the United States. Secondly, I would call it bad policy to offer the same countries the ability to sell "off-sets" when they have not adopted any caps on emissions. Such an approach would truly put the American farmer and businessman at a competitive disadvantage.

My recommendation to the Committee would be to allow international off-sets to be considered for purchase, only after a certain level of domestic off-sets have been utilized, set at a sufficiently high level to assure that all agricultural producers have the opportunity to benefit from such a program. This approach shows a true investment in the American economy (at this much needed time) and does not totally create a trade barrier with other nations.

- 3) As you know, many dairy and hog producers are going through a historic economic downturn in their respective industries. Several hog and dairy producers are tens of thousands of dollars of equity with each passing week. Any analysis that shows a positive impact on these producers assumes that operations of a certain size will install an anaerobic digester to benefit from carbon offsets. Considering the high costs of this equipment and the fact that the climate change legislation would start in 2012, do you believe that most producers would be able to finance this type of equipment in the next 12 to 18 months?

- Thank you for being aware of this. I am a dairy farmer and I know.
- I don't have any analysis that shows a positive impact.
- There is a very easy way to capture carbon offsets.
- You can cover any size manure pit and lagoon and flare off the gases.
- if there is a good price for credit; this would be a very reasonable way to capture credits.
- Maybe a small grant to help cover lagoons would help in these low commodity prices for hog and dairy farmers.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Chairman Gary Gensler
 September 9, 2009

Chairman Tom Harkin

- 1) As Congress considers reforms of the Commodity Exchange Act, what modifications would be necessary to provide the authority for CFTC to effectively regulate trading in both the cash and futures markets for emission allowances and offsets?

Senator John Thune

- 1) H.R. 2454 allows third parties, such as investment banks or foreign nations to participate in the carbon market. In other words, third parties that are not directly associated with carbon offsets would be able to purchase these credits on an exchange. Does this leave the carbon market open to undue influence or manipulation? Under this scenario, would a third party or a group of third parties be able to drive up the price of carbon by purchasing large amounts of carbon allowances or available carbon credits?

What role will speculators play in the carbon market? How will you define a speculator? How will you define excessive speculation?

- 2) As you know, the House cap and trade bill gives jurisdiction over the carbon-based derivatives to the CFTC, with the Federal Energy Regulatory Commission overseeing cash transactions in the allowances themselves. Standalone legislation has been introduced in the Senate that would give the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market. Would you compare and contrast the benefits or drawbacks of giving the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market?
- 3) We have heard estimates that the future carbon market under a mandatory cap-and-trade proposals will total several billions of dollars up to two trillion – according to CFTC Commissioner Bart Chilton. What is your estimate for the carbon futures market? What is your estimate for the carbon cash market? What is the size of these markets today?
- 4) As you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

- 5) How will the CFTC work with EPA to determine when or if carbon allowance reserves should be tapped? Are these reserve thresholds adequate to keep carbon costs steady?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System

Questions for the record

Mr. Joseph R. Glace

September 9, 2009

Chairman Tom Harkin

- 1) Can you break down the costs of the over-the-counter transaction for me? How much does it cost to conduct business on exchange versus off-exchange? What are the indirect costs associated with wider bid-ask spreads in the over-the counter markets compared to exchange trading? How much more would electricity cost your customers if you could only hedge on regulated markets with stricter margin and capital requirements?

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?
- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

Senator John Thune

- 1) Can you provide an example of why two market participants would need to use the Over the Counter (OTC) market for a transaction in the carbon market place?

In your testimony, you mentioned that forcing these unique transactions onto an exchange would dramatically drive up costs. Could you provide this committee with a better perception of why this requirement would increase costs, and how much would costs increase on account of such a requirement? With regards to these transactions, what specific types of information should be reported to ensure transparency while still maintaining the confidential information of the emitter and trader?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Dr. Dave Miller
September 9, 2009

Chairman Tom Harkin

- 1) In your written testimony, you discussed the challenges of establishing standards for offsets. You also mentioned the costs associated with assuring the value of offset activity and that the cost could become prohibitive. Given your discussion of complicated design protocols and uncertainty about valuing offsets, would you support discounts on offsets as a mechanism to address some of the valuation and verification problems inherent in an offset program? If so, should the offsets be discounted by a standard percentage or should the discount reflect expected leakage or nonperformance?

Senator Chuck Grassley

- 1) Do you believe that it is possible for the average farmer, in Iowa or elsewhere, to recover his increased input costs, in terms of higher fuel and fertilizer prices for example, that would be caused by a cap and trade system like in the Waxman-Markey Bill, by selling offsets?
- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
- 3) Of the sources of ag offsets, one of the most frequently mentioned is shifting to no-till, but the EPA analysis admits that "agricultural soil sequestration does not show significant supply." Another option is reducing fertilizer use, but the EPA model showed what any farmer could tell you that this results in a decline in yields. Another often discussed offset possibility would be for farmers to install an anaerobic digester, but those can cost hundreds of thousands of dollars and a federal AgSTAR program report found that anaerobic digesters are feasible for only what amounts to about 1 percent of Iowa farms. How would a typical farmer in Iowa be able to receive any significant benefit from selling carbon offsets?
- 4) In order for farmers to get paid for sequestering carbon dioxide in the soil, they would have to switch to no-till, but many farmers have already been using no-till for many years where it's possible to do so. Any farmer that was using no-till before the date we establish in law would not be eligible for payments. This could result in two neighboring

farmers using no-till where the one who had switched over years ago would not see a dime and the Johnny-come-lately would receive a check for doing the exact same thing that his neighbor had been doing all along. This would surely strike most farmers as fundamentally unfair. What can be done to address the fairness issue?

- 5) We've heard a lot about opportunities for farmers to sell offsets, but it's not always clear how exactly that would work in practice. Since the farmer would actually be selling on a carbon market and offsets would need to be verified and registered, I imagine the process would be a little different from signing up for a FSA program for instance. Could you walk me through the process a farmer would undertake to receive payment of an offset through let's say USDA, for sake of discussion?
- 6) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?
- 7) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Timothy Profeta
September 9, 2009

Chairman Tom Harkin

- 1) You said in your testimony that there is a fundamental trade-off between “Mitigating systemic risk and creating additional cost of posting margin.” It seems that a lot of our legislative choices come down to this type of calculation, over-the-counter transactions where businesses don’t need to put up a lot of cash to do business and exchanges where they expect you to put up some money to back your bets. But if the regulatory system does not deal effectively with systemic risk, such as that posed by OTC trading, are there not costs to that? I’m referring to the costs of using intermediaries like dealer-banks, or volatility, or economic downturns, or taxpayer-funded bailouts.

There are costs embedded in over-the-counter instruments. Cost comparisons typically compare the cash required to post margin for an exchange trade with the fact that OTC contracts may allow purchasers to pledge physical assets as collateral rather than posting cash margin or perhaps not require any collateral at all. By not requiring cash margin, OTC instruments may allow entities to use their cash flows for other purposes. OTC instruments may have transaction costs embedded in the price of the contracts, however.

Events over the past year make it clear that large markets failures can affect broad sections of the economy. Excessive risk-taking in the credit default swap markets, for example, has resulted in significant costs to society, not only through taxpayer-funded bailouts, but also through restricted credit markets and significant loss of value across securities markets. In terms of a carbon market, the cost of large scale market failures could include undermining the nation’s approach to addressing climate change. Congress can take steps to avoid these types of failures in the carbon market by ensuring that market participants properly capitalize financial risks. Reduced leverage, larger capital requirements and prudent margin requirements are all necessary parts of the solution. However, the elimination of regulatory arbitrage is also a key to a stable market, with regulators having sufficient information to evaluate the risks to which market participants are exposed.

As Congress moves forward with climate change legislation, it will have to balance the risks and costs posed by OTC instruments with the flexibility and lower cash requirements that these instruments provide for market participants.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

The evolution of the OTC market over the last ten years is highlighted by the increase in "exotic" derivatives. Plain-vanilla OTC derivatives, such as interest-rate swaps, have been around for approximately thirty years.

There are two arguments for how OTC instruments keep costs low. The first argument is that OTC contracts provide entities with the flexibility to determine the most cost effective means of hedging risk. Entities may choose OTC instruments because the instruments are not available on exchanges, such as long-dated contracts, or they need an instrument that is specifically tailored to their business needs. The second argument is that OTC contracts may allow companies to avoid tying up their cash reserves by posting margin. Exchange-traded products require initial margin and variation margin posted on a daily basis in cash (or near cash, such as government securities). A customized OTC contract can have specific parameters written into it that allows changes in the frequency for variation margin to be posted (i.e., not daily). OTC contracts may also allow companies to assign non-cash collateral as initial margin or, in some circumstances, not post collateral at all.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

There are different levels of transparency in the current commodities markets regulated by the CFTC, depending on the type of commodity and where the commodity trades. While broader market reforms currently under consideration may increase transparency in commodities markets, these efforts are still underway and it is impossible to predict what the final requirements will be. Because Congress would be creating the carbon market *de novo*, the legislation could ensure that the market regulator has jurisdiction over the entire marketplace and can track all transactions involving carbon allowances or associated derivative instruments, regardless of who is involved in the trade and where the trades occur.

Unlike traditional commodities, emission allowances issued pursuant to federal climate legislation will likely have unique serial numbers, allowing regulators to track ownership of the allowances with the proper reporting requirements. The legislation or implementing regulations could achieve transparency in the derivatives markets by requiring reporting from exchanges,

clearing organizations, trade repositories, and intermediaries such as brokers and dealers. If over-the-counter instruments are allowed in the carbon market, the rules could also require reporting directly to the regulator if the transactions are not cleared or reported to trade repositories.

Senator John Thune

- 1) Relative to other commodity markets, how large will the carbon market be? Is it possible to establish unique regulations that will result in efficiency and transparency of such a large carbon market within two years?

The Clean Energy Jobs and American Power Act would create a substantial new carbon market but would not be larger than many existing commodity markets. Economic modeling conducted by the U.S. EPA suggests that the price of emission allowances would likely be around \$13 per allowance in 2015. Just over five billion allowances would be issued that year, resulting in an allowance market worth approximately \$65 billion. As a general rule, commodities trade between 6 and 9 times their underlying value in the futures market. This suggests that the derivatives markets could exceed \$390 billion in the early years. In comparison, the value of global crude oil markets traded on the Intercontinental Exchange (ICE) and NYMEX exceeded \$17 trillion in 2008. Global futures for cotton and sugar trading on ICE reached \$154 billion and \$543 billion in 2008, respectively.

It is possible to create an efficient and transparent regulatory system to oversee trading in the carbon market. The major legislative proposals for regulating the carbon market, including the American Clean Energy and Security Act that passed the U.S. House of Representatives in June of this year and the Carbon Market Oversight Act of 2009, introduced by Senators Diane Feinstein and Olympia Snowe, are founded upon the existing CFTC regulatory model. Both bills adopt many aspects of the Commodity Exchange Act and add specific requirements to address the unique aspects of the carbon market, including some best practices from existing securities regulations. The CFTC would build upon its existing expertise rather than creating an entirely new regulatory system.

- 2) As you stated in your testimony, a cap and trade scheme will create two markets, a cash market that will trade allowances from the current year, and a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances. Should both markets be regulated by the CFTC? If so, what are the potential pitfalls of splitting the regulatory responsibility with another agency? If not, what additional resources will the CFTC need to carry out this responsibility within the next couple of years?

The CFTC is well-positioned to regulate both the spot and derivative markets for carbon allowances. The cash and derivative markets will be highly correlated and it would be most efficient to have one regulator with its eyes on the entire carbon market complex, including OTC derivatives. The recent failures in the credit default swaps markets highlight the problems caused by relying on multiple regulators to oversee various aspects of the same market.

Additional pitfalls for splitting regulatory authority include the potential for turf wars and a history of poor cooperation between various government agencies.

Generally, the CFIC will need sufficient resources to oversee the carbon market; the key to good regulation is a well-funded and vigilant regulator. I am not in a position to estimate the additional resources that will be necessary. Chairman Gensler and his staff may be able to provide you with a specific answer.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Frank Rehermann
 September 9, 2009

Chairman Tom Harkin

I am concerned that global warming's impacts – longer droughts and heat waves, increased pests, and increased disease may well be the biggest threat to farmers' abilities to make a profit.

- 1) Have you considered the potential drawbacks of inaction? How global warming will directly impact your industry?

The USA Rice Federation does not oppose responsible efforts to curb greenhouse gas emissions or climate change, including approaches such as increased use of renewable energy sources, nuclear energy, conservation, enhanced efficiencies, and other approaches that would not harm the U.S. economy or cost American jobs. We are deeply concerned that the cap and trade bill emanating from the House and similar approaches would be especially harmful to family farm operations like mine. The pending cap and trade proposal would substantially increase production costs and lower net income, threatening the economic viability of the farm. Meanwhile, I have little confidence that our trading partners will bind their farms and industry to equally rigorous emission reduction requirements, if any at all.

Senator Pat Roberts

- 1) You mention the AFPC study by Texas A&M. The representative rice farms experience lower average annual net cash income and at the same time an increase in annual costs. How does this study affect a producer's relationship with his or her lender? Credit is certainly tight already. Do you expect it to become even tighter if cap and trade legislation were to pass? How does this affect beginning farmers and ranchers?

The impact of pending cap and trade legislation ranges from even tighter margins for some to negative cash flow for others. The effect is to erode a producer's equity position, something lenders look unfavorably on when making lending decisions. For producers in the latter end of the range and especially for small and beginning farmers, the impact of cap and trade legislation could prove decisive in a lender's decision, while producers in the former range are on the bubble. This is why, in our testimony, we urge Congress to authorize the Commodity Credit Corporation to cover any increased production costs.

- 2) If H.R. 2454 were to become law, how would a rice farmer overcome the higher input costs? Would one 'good' year be enough to cover current costs plus addition direct and indirect costs associated with climate change?

We are concerned that some producers simply would not be able to overcome the higher costs and our concern is predicated on a normal or good production year as yield fluctuation from year to year is not as great as it is with respect to many other crops. Production costs and price are principle determinants on how a rice producer fares in a given crop year and the first factor is going to be greatly influenced by this legislation. Note that this is only the production side of the equation. Unlike most other commodities, rice must ordinarily be processed (i.e. milled) before it can be widely marketed in commerce, meaning there will also be increased costs borne by the producer in putting the commodity in the form necessary to market the crop. In fact, generally, rice farmers participating in cooperatives can expect to face a whole other hit in the form of lower patronage refunds, or dividends, on account of the cooperative's increased cost of doing business. And, all of this is predicated on the uncapped treatment of the agricultural sector precluding EPA-imposed performance standards or other prescriptions that the Agency could still impose under other provisions of the bill or the underlying Clean Air Act. There is no effective exemption for production agriculture and necessary processing is not even covered under the definition of agriculture sector. If cap and trade is to go forward, at minimum, there needs to be a clear exemption for agriculture production, including necessary processing.

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

Senator, as a farmer, you can appreciate that if there is a clear and responsible way to cut production costs, a farmer will do it. Few stones have been left unturned in this respect. You also know that we are price takers, so we cannot increase the price on the market. One way to offset increased costs associated with cap and trade is through the sequestration or reduction of carbon. However, as I noted in my written and verbal testimony, today that is not an economically viable and proven option for rice farmers. The only choice we are left with is to absorb the increased costs and hope to still make ends meet.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

In rice, we see no economically viable opportunity at present to avail ourselves of the offset program being discussed. We are working to develop some possibilities but we are simply not there yet. The primary objection to the forestation option is that farmers and ranchers are not foresters. Beyond that, even if we were to attempt to go that route, it would seem to me that it would involve an enormous upfront investment without the possibility for any real pay off till years down the road when the trees mature. This is a possibility for large pulp and paper companies but not to farm and ranch families.

- 3) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator, we appreciate your leadership in rejecting what was on the table in the Doha Round negotiations late last year because the agreement meant deep and, in our estimation, unsustainable cuts to U.S. domestic support in exchange for what amounts to illusory concessions from our trading partners. We have no doubt that a similar tact is being taken with respect to global climate change and the curbing of greenhouse gas emissions, as evidenced by recent media reports of comments made by Indian officials. The combination of Doha Round and climate change legislation could very well result in the kind of severe hemorrhaging of American agriculture and the jobs that go with it that we experienced in the manufacturing sector earlier this decade. So, we appreciate the tough stance that you, Chairwoman Lincoln, Ranking Member Chambliss, and others have taken in both regards.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

As noted in our response to earlier questions, we are unaware of any proven viable opportunities for rice producers to generate and market offsets in the near future.

In a world of 6.7 billion hungry people, the great majority of whom do not have the means or disposable incomes that we Americans do, we strongly reject the notion that there is greater societal or global benefit to planting trees on our rice-fields than farming them. Ours are some of the most productive acres in the world, and we would rather continue to pursue the more noble purpose of feeding the world as long as we can stay in business.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Although rice is unable to participate in the agricultural offset program, we believe that U.S. agricultural offset opportunities should not be capped. With respect to international offsets, among other things, it would seem that there would be enforcement issues that could undermine the integrity of the program, so the larger the international program the greater the uncertainty may be relative to the program's effectiveness. However, since

rice farmers are not able to effectively participate in the offset program, we have not closely examined the implications of capping international offsets. We believe the program should be structured such as to increase demand for U.S. offsets and therefore increase the value of such offsets, rather than disadvantage U.S. offsets relative to those in the international market.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System

Questions for the record
 Ms. Julie Winkler
 September 9, 2009

Chairman Tom Harkin

- 1) One of the more frequent complaints we hear about central counterparty clearing is that the costs associated with clearing are too expensive and that it would tie up capital that could be better invested. Could CME Clearport accept illiquid assets such as real estate or stocks and count that towards margin or capital requirements? Could you net cash and futures positions in a market where the cash and futures transactions are executed on the same platform? What other options are there to mitigate cost concerns of margin and capital requirements without compromising the integrity of the clearinghouse?

ANSWER: *Collateral that is readily convertible to cash is an essential element of the safety of a central counterparty clearing system and the only means to avoid the creation of systemic risk. The central counterparty (CCP) must hold sufficient liquid collateral to enable it to immediately meet the obligations of a clearing member—customer which defaults, since the CCP must immediately fulfill the obligations of the defaulting clearing member to each counterparty. There is no way to do this, without adding debt to the system, if the clearing house is holding illiquid assets, such as real estate, as collateral. The Green Exchange Venture currently uses CME Clearing as its CCP. CME Clearing has never experienced a default in its 110 year-plus history. CME Clearing does accept readily marketable securities, but discounts their value in a manner appropriate to recognize any likely illiquidity at the time that they must be sold to cover a loss.*

CCP's are not in the business of lending to customers. That would simply magnify the risk of operating a CCP and defeat the purpose of centralized clearing. If a customer with real estate assets needs to collateralize a cleared position, she may secure a loan from a bank and use the proceeds of the loan to purchase interest bearing securities, which may be used to collateralize her obligations to the CCP.

It is possible, in certain circumstances, to use a physical allowance to collateralize a derivative position. For example, a trader who is short an allowance futures contract may be able to collateralize his position, in whole or in part, with allowances of similar maturity.

- 2) If legislation establishing greenhouse gas emission allowances and offsets, required that all trading of the allowances, offsets and their derivatives take place on regulated exchanges, and if there is sufficient market interest for allowances 5, 10 or even 20 years in the future, would an exchange be able to offer futures contracts of longer duration? What are the practical considerations that would affect the decision to develop longer-term contracts?

ANSWER: Some futures contracts are long-dated and have adequate liquidity. For example, NYMEX's Natural Gas futures contract extends out 12 years and CME's Eurodollar futures contract extends out 10 years. However, exchange traded derivative contracts of these durations are the exception, not the rule. Price integrity is the critical component to offering long-dated futures contracts as the clearinghouse must be able to determine adequate performance bond coverage for the contracts and protect against default. Each contract month listed in a long-dated futures contract that has open interest will require a daily settlement process to employ the daily mark-to-market functions of the CCP. If legislation created a cap-and-trade program in which allowances were used for compliance over 5, 10, or 20 year periods then long-dated emissions contracts could be designed and offered by exchanges such as the Green Exchange Venture.

However, there could be challenges in generating sufficient liquidity for the long-dated instruments on an exchange. Cap-and-trade participants may be focused on shorter-term compliance obligations involving near-term compliance deadlines that can be satisfied using actual allowances and offset credits that are in their possession or in circulation. The cap-and-trade program could address this by ensuring that there are longer-term vintages of allowances distributed and in circulation. This would provide market participants with a greater certainty about the physical supply of allowances in future years. This may result in greater hedging interest and trading activity in 5, 10 or 20 year carbon futures contracts. Without such certainty of the physical supply of allowances in future years, it is unlikely that adequate liquidity will exist for long-dated exchange-traded contracts.

- 3) I see you are opposed to a transaction fee, such as we've seen in the House-passed climate change legislation. If we were to propose a user fee on these transactions to fund regulatory agencies, what would be the best way to structure it – for example, per exchange member, per transaction, per month, per year?

ANSWER: Funding for market oversight should be generated from more appropriate sources. Most cap-and-trade legislative proposals contemplate an auction for some portion of the allowances. For example, it would take less than one percent of the expected revenues from the auction proposed in the House's American Clean Energy Security Act to fund CFTC's current budget. By tying the funding of oversight resources to allowance auction revenues rather than exchange transactions, all relevant agencies (e.g., USDA, CFTC, EPA) will have resources for all of the elements that are necessary for effective emissions market oversight.

Exchange users pay trading fees which are used to fund exchange operations and the exchange's self regulatory oversight to ensure and compliance with statutory and regulatory requirements. Any additional user fee, based on transactions or targeted at only members of exchanges, will add transaction costs and make less or unregulated trading venues more attractive compared to regulated exchanges. This will impair liquidity and defeat efforts to encourage transparent, regulated trading markets.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

ANSWER: First, there seems to be a mistaken impression regarding the length of the existence of OTC contracts. Such contracts have actually been utilized for more than 20 years in energy commodities. Second, the reason such contracts came into existence is precisely because they provided innovative, lower costs ways to finance investments; indeed, in some cases, they enabled projects to get financed that otherwise could not have gotten financed at all. Furthermore, they will be the most vital in the early days of any new industry or new industry phase, which will clearly be the scenario in place upon passage of emissions control legislation. This is because the sector will essentially be "inventing" itself--that is, ramping up from a state of de minimis investment in demonstration projects to a full scale commitment to transform the entire societal energy infrastructure. No one yet knows how this will most efficiently be accomplished, so there will be no way to accurately standardize the necessary transactions.

As was stated in my written testimony, the OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies. If such OTC contracts are required to efficiently finance such projects, forcing all trading onto exchange-based platforms is likely to increase costs to utility customers.

Exchange cleared transactions require posting of liquid collateral; some entities may be able to secure more flexible terms for collateralizing their obligations in the OTC market. For example, a customer in the OTC market may be allowed to collateralize its obligations on an OTC contract by granting a lien on a physical asset. The ability to collateralize obligations to counterparties by means of liens on physical assets may

benefit power producers or agricultural offset project developers. Lower financing costs for OTC hedging transactions may translate into lower power costs to consumers.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

ANSWER: We believe that greater transparency should be required of the OTC carbon market and that all carbon-related OTC positions should be reported to the CFTC. This reporting combined with the high level of transparency available through the Green Exchange Venture will provide the additional transparency that is needed for oversight of a U.S. carbon market.

As was stated in my written testimony, CME Group will provide the market and trade surveillance services to the Green Exchange Venture. CME's highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Green Exchange Venture also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. On behalf of the Green Exchange Venture, CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Fred Yoder
September 9, 2009

Chairman Tom Harkin

You've indicated that you think those farmers who have already engaged in practices that reduce greenhouse gas emissions should be rewarded for their early actions.

- 1) Let's take the example of a corn farmer who started to use no-till practices in 2006. How should those practices over the past few years be treated in global warming legislation? And, does it make a difference whether the farmer sold carbon sequestration credits derived from those practices on the Chicago Climate Exchange?

Senator Pat Roberts

- 1) In your testimony, you mention "economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program." Since analysis shows both significant agriculture production cost increases and increased commodity prices due to a reduction in farm land acreage even with an offset program, won't consumers still feel the effects of these higher costs and prices?

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?
- 2) You mention that treatment of early actors, especially those who have adopted conservation tillage practices prior to 2001, should not be penalized in the carbon offset program developed. Do you have recommendations on how to address this issue, in particular for the earliest adapters as you have highlighted?
- 3) EPA numbers suggest very high cost increases to use coal. Since the Corn Belt primarily uses coal to provide our energy needs, do you believe that fuel switching will occur? To which types of fuels? What does this mean for our rural communities?

- 4) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
- 5) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator John Thune

- 1) If under a cap and trade system, ag producers are asked to sign a long-term contract, but only receive benefits of carbon sequestration for a few years or until the soil is saturated with carbon, do you think your members are likely to participate?
- 2) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
- 3) Do you believe fertilizer prices will increase under a cap and trade system? If so, how high may fertilizer prices increase? Do you believe we will have a greater reliance on foreign sources of fertilizer?

In the later years of the House-passed cap and trade bill, "energy intensive trade exposed" industries including the fertilizer industry, no longer receive free allowances. What impact will that have on the fertilizer industry and the price of fertilizer? If most early acres of conservation tillage are saturated with carbon at this point, what impact will these two scenarios have on the cost-benefit analysis for feed grain farmers in the Midwest?

- 4) How should Congress treat the early actors of conservation practices? For example, South Dakota already had 2.8 million acres in no-till, which would not receive credit under the House-passed climate change bill since these acres were in no-till before 2001. Should these producers be able to participate in the carbon market? If so, how should these acres be treated?
- 5) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Andy Beckstoffer
 September 9, 2009

Chairman Tom Harkin

You mentioned this briefly in your written testimony, but I want to spend a little bit more time discussing the impact that climate change is already having on your crops. I think this is an important topic to address because it illustrates the fact that there is a cost to doing nothing when it comes to climate change. For example, you mentioned more heat spikes, higher nighttime temperatures, and new pests and diseases as challenges that are beginning to emerge for your industry.

Even if we do not yet fully understand how all of these things will impact your business as a winegrape grower, surely these are challenges that concern you.

1. As a winegrape producer with over 30 years of experience in agriculture, could you talk a bit more about the business risks that climate change presents to your operation now and in the future?

On page five of my testimony I discuss more frequent heat spikes to which we have adjusted by installing trellises that we can alter on short notice to deal with heat spikes. We can adapt with proper viticultural practices at considerable expense, but it is necessary to maintain the quality of our premium winegrapes. There have been limited studies to assist the wine community in understanding the potential impacts of climate change to the quality and productivity of winegrape vineyards. However, the data we collect from vintage to vintage shows that we can adapt and that the maximum temperatures haven't changed so much – but that the minimum temperatures have risen, and that is something for which we must continually make adjustment. It is the extreme heat incidents and temperature changes, not the averages, that represent the most risk.

There is no doubt in my mind that much more needs to be done to identify suitable rootstocks and conduct new rootstock breeding programs to facilitate our adaptation. Of course, that is a years long – if not decades long – process and one that must be conducted in the context of changing consumer taste profiles and expectations. There is a five-year delay from the time I plant a vineyard to the time it reaches the consumer in a bottle. North Coast development costs for a new vineyard run from \$25,000 to \$40,000. Our capital investment is made for at least a 25 year period. That is why we invest so heavily in cutting-edge viticultural practices to adapt to things like changing temperatures.

Irrigation is critical to adaptation. The lower snow pack forecast by the experts and changing rainfall patterns present a very real risk to our businesses. Our quality, our productivity, and our profitability are dependent upon adequate water which we manage precisely with the most advanced technology in plant monitoring and water application.

The California Sustainable Winegrowing Program is an integrated whole farm approach to decision making that helps participants better understand and evaluate the trade-offs and impacts of each practice. It is an important tool for helping us adapt to changing resource and regulatory concerns.

The uncertainties presented by climate change and the scarce allocation of resources like water underscore the most important investment government can make: funding agricultural research and extension to assure that farmers and ranchers have the ability to continue adapting to meet the food and fiber needs of the world's rapidly expanding population.

2. Do you have any suggestions on how we could better educate farmers in other parts of the country about the implications to their livelihoods if nothing is done to address climate change over the decades to come?

Senator, this is surely not my area of expertise! However, the Committee might consider conducting field hearings in different regions of the country. It should also conduct hearings for researchers and extension personnel to provide information about the potential impacts of climate change to farmer and rancher livelihoods.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

While considerable research and demonstration of the advantages of no-till and minimum tillage practices has been done, not nearly enough research has been done to quantify the benefits of other practices and document their value as measurable, verifiable carbon and GHG offsets. Just a few of the ag practices that have the potential to produce significant offsets include cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops -- vineyards; orchards; hay; and dedicated fuel crops.

This is why it is critical that USDA with its technical and scientific expertise of agricultural and farming practices have the primary role in developing ag GHG reduction or sequestration parameters for carbon offset protocols.

We plant our vineyards for an economic life of 20 years. Unless we are given credit for past and ongoing carbon sequestration, this legislation is of very little value to winegrape growers.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Farmers and ranchers must not be put at a competitive disadvantage in international trade. California winegrape growers face vigorous competition from other wine producing countries with lower costs of production.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

Those practices for which research has already been completed and protocols approved are planting trees (forestry) and conservation tillage. Therefore they are best positioned for measurable and verifiable offset credits. There is great potential for other ag practices to produce significant offsets and other environmental benefits from cover crops; modified fertilizer techniques; crop and residue waste management schemes; biochar; and the role of perennial crops – vineyards; orchards; hay; and dedicated fuel crops.

It is very important that winegrapes and other perennial crops be given credit for carbon sequestration of past and continuing practices. We plant our vineyards for an economic life of 20 years. Thus, if credit is given only for new plantings, the legislation would be of little help to winegrape growers.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Domestic offsets should not be capped.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Luke Brubaker
September 9, 2009

Chairman Tom Harkin

In your testimony you mentioned being able to sell carbon credits for reducing greenhouse gas emissions through the use of your digester.

1) Can you tell us more about the economics of that project, please?

a. What was the total project cost and what is the annual income.

- Total project cost was \$1.25 million dollars.
- This year's income will be approximately \$200,000.00 for the sale of electric.

We derive a savings of approximately \$40,000 as a result of not needing to buy bedding for the cows. We separate the solids from the liquid and use it to bed the cows instead of buying wood shavings or saw dust.

We sell separated solids to other farmers. \$10,000 was derived from the sale of solids.

Sale of credits sold: about one-half sold for 20 years. What we sold equals over \$100,000 which when invested for 20 years approximately doubles the money.

b. How many credits does your system generate, how do you sell the credits, and at what price?

- KW = tons of carbon to sell taken out of the air.
- Sold to a trading company.
- The market fluctuates.
- We sold at a good time--\$3.00 to \$4.00 a ton.
- I believe the market is a lot less now.

- c. How does the income from the credits compare with the income from selling the electricity?
- A lot less for the sale of credits than sale of electricity.
 - With a good cap and trade bill, it could mean a lot more money for the credits.

Senator Pat Roberts

- 1) How many head of cattle does it take to make a methane/manure digester functional and economical?
 - A good number would be 500 head or more.
- 2) What is the annual operation and maintenance cost for a methane digester?
 - \$10,000 to \$25,000; this depends on the amount of repairs.
- 3) Does the functionality of a digester change with head count, feed content, or seasonal change? If so, how does this affect normal day to day operations and management ability?
 - Yes. In the summer, if there is more water in the manure, because of cooling the cows, it takes more volume of manure to make the same amount of electricity.
 - Adding other food products make extra electricity.
 - A little more setup on the computer system to add other feed or food by-products.
- 4) Do you believe a digester would work on a cow-calf operation, feeder cattle operation or for a small feedlot?
 - If the manure is in a liquid form that the manure can flow, it could work.
 - Getting the manure to the digester as quickly as possible is the key before it loses the gases into the air.

Senator Chuck Grassley

- 1) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?
 - I believe agriculture has a great opportunity with the use of conservation practices: no-till, cover crops, and methane digesters.
 - The bill must more than offset any higher cost the farmer would incur.
 - I do believe planting trees and forest management would be a big part of the program, but I am not sure if would benefit most of agriculture.

- 2) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement; will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.
 - I think your statement is very true.
 - If a bill is written wrong, it would be devastating to agriculture.
 - Imports may have a tendency to come into the country like fertilizer, dairy products and fruits, etc. if U.S. products are priced out of the market.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?
 - In order: Planting trees, grasslands, no-till, cover crops, and methane digesters.
- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?
 - My farming operation put forth a significant capital investment in order to install the methane digester, which is a clean, efficient and an American source of renewable energy. I do not think it would be a good idea to cap domestic agricultural off-sets as proposed in the U.S. House version of the Climate Change legislation. There does not seem to be any sound policy rationale for placing a cap on such offsets, like those produced by my farming operation, that supply clean and efficient domestic energy and provide a valuable environmental benefit.

There may, however, be appropriate reasons for considering caps on international offsets for two reasons. First, many people argue that this legislation would drive American jobs off-shore. Without a cap on foreign off-sets, the purchase of such off-sets may also be driven off-shore, where there is little regulation and these off-sets would be feasibly cheaper than the same type of off-sets in the United States. Secondly, I would call it bad policy to offer the same countries the ability to sell "off-sets" when they have not adopted any caps on emissions. Such an approach would truly put the American farmer and businessman at a competitive disadvantage.

My recommendation to the Committee would be to allow international off-sets to be considered for purchase, only after a certain level of domestic off-sets have been utilized, set at a sufficiently high level to assure that all agricultural producers have the opportunity to benefit from such a program. This approach shows a true investment in the American economy (at this much needed time) and does not totally create a trade barrier with other nations.

- 3) As you know, many dairy and hog producers are going through a historic economic downturn in their respective industries. Several hog and dairy producers are tens of thousands of dollars of equity with each passing week. Any analysis that shows a positive impact on these producers assumes that operations of a certain size will install an anaerobic digester to benefit from carbon offsets. Considering the high costs of this equipment and the fact that the climate change legislation would start in 2012, do you believe that most producers would be able to finance this type of equipment in the next 12 to 18 months?

- Thank you for being aware of this. I am a dairy farmer and I know.
- I don't have any analysis that shows a positive impact.
- There is a very easy way to capture carbon offsets.
- You can cover any size manure pit and lagoon and flare off the gases.
- if there is a good price for credit; this would be a very reasonable way to capture credits.
- Maybe a small grant to help cover lagoons would help in these low commodity prices for hog and dairy farmers.

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Chairman Gary Gensler
September 9, 2009

Chairman Tom Harkin

- 1) As Congress considers reforms of the Commodity Exchange Act, what modifications would be necessary to provide the authority for CFTC to effectively regulate trading in both the cash and futures markets for emission allowances and offsets?
 - A. Currently, the CFTC has exclusive jurisdiction over futures contracts, options on futures contracts, and options for emission allowances and offsets traded on a Designated Contract Market (DCM) or Derivatives Transaction Execution Facility (DTEF). The CFTC has only limited enforcement authorities over cash market transactions.

If Congress chose to have the CFTC regulate cash market transactions in emission allowances and offsets, the Commodity Exchange Act (CEA) would need to be amended to create such authority.

Depending on whether contracts for emission allowances and offsets fit the definition of excluded or exempt commodity under the CEA, futures, options on futures, and options for allowances and offset could be conducted bilaterally and be largely excluded from the CFTC's authority. To avoid this, Congress would have to provide the CFTC with explicit authority over carbon emission allowance and offset swaps.

Senator John Thune

- 1) H.R. 2454 allows third parties, such as investment banks or foreign nations to participate in the carbon market. In other words, third parties that are not directly associated with carbon offsets would be able to purchase these credits on an exchange. Does this leave the carbon market open to undue influence or manipulation? Under this scenario, would a third party or a group of third parties be able to drive up the price of carbon by purchasing large amounts of carbon allowances or available carbon credits?

What role will speculators play in the carbon market? How will you define a speculator? How will you define excessive speculation?

A: A primary indicator of the ability to effect a manipulation of commodity markets is the ability to exert market power. Past enforcement cases brought by the CFTC have involved both speculators and commercial hedgers who accumulated and sought to exert

market power. Any party or groups of parties acting in concert could conceivably attempt to corner or squeeze a market independent of whether there are commercials or speculators.

The role that speculators will play in a carbon market will ultimately be dependent upon whether Congress enacts any changes to existing law. Under current law, speculators are free to participate in emissions derivative markets.

The CFTC has not defined what constitutes excessive speculation.

- 2) As you know, the House cap and trade bill gives jurisdiction over the carbon-based derivatives to the CFTC, with the Federal Energy Regulatory Commission overseeing cash transactions in the allowances themselves. Standalone legislation has been introduced in the Senate that would give the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market. Would you compare and contrast the benefits or drawbacks of giving the CFTC jurisdiction over both the derivatives and cash transactions of the carbon market?

- A. The CFTC does not currently regulate any cash market. However, the agency has extensive experience in regulating centralized derivatives markets. The benefit of giving the CFTC oversight of cash carbon markets is that cash carbon trading would be occurring under federal oversight and conceivably be subject to regulation ensuring transparency, openness and fair and orderly markets—depending on what authorities Congress sought to provide.

The CFTC is not aware of any drawbacks to such an approach beyond the fact that such an approach would require significant additional resources.

- 3) We have heard estimates that the future carbon market under a mandatory cap-and-trade proposal will total several billions of dollars up to two trillion – according to CFTC Commissioner Bart Chilton. What is your estimate for the carbon futures market? What is your estimate for the carbon cash market? What is the size of these markets today?

The CFTC has no estimates of the expected size of the carbon futures markets under HR 2454. However, there are some estimates available for the expected size of the carbon cash market based on the cap-and-trade regime under the Waxman-Markey legislation.

These estimates are

\$60 billion in value in 2012 (Congressional Budget Office)

\$72 billion in value in 2012 (Energy Information Administration)

\$76 billion in value in 2020 (Environmental Protection Agency).

Currently futures and options contracts on the carbon emission (greenhouse gases) are traded on two futures exchanges: Chicago Climate Futures Exchange (subsidiary of the Chicago Climate Exchange) and NYMEX.

Products traded are

Regional Greenhouse Gas Initiative (RGGI) CO₂ allowance futures and options contracts;
 Carbon Financial Instrument (CFI) futures and options contracts;
 Climate Action Reserve offsets futures and options contracts;
 Certified Emission Reduction (Enropcan) futures and options contracts;
 European Union Allowance (European) futures and options contracts.

The notional value for the subject contracts for the 2009 calendar year was

| | |
|---------------------|------------------|
| Total value: | \$232,258,536.19 |
| Total NYMEX: | \$171,429,033.05 |
| Total CCFE: | \$130,633,411.50 |

Over-the-counter transactions are neither regulated nor transparent so there are no reliable statistics for carbon emissions related over-the-counter transactions.

- 4) As you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

A. The CFTC does not have a viewpoint on whether or how caps should be implemented. As the CFTC understands it, caps are intended to achieve particular policy objectives related to ensuring an overall reduction in carbon emissions and as a cost containment mechanism. Such caps could clearly have an impact on market structure as they have the potential to impact the available supply of carbon instruments, but what that impact might be is difficult to predict until more is known about how carbon markets will be structured.

- 5) How will the CFTC work with EPA to determine when or if carbon allowance reserves should be tapped? Are these reserve thresholds adequate to keep carbon costs steady?

A. The CFTC is not currently a price setting agency. It regulates to ensure fair and orderly markets, not to achieve particular price objectives. The CFTC has not conducted any economic analysis of potential carbon reserve proposals.

If the CFTC were directed to oversee a carbon reserve program the CFTC would implement the statutory directives and work with other agency partners that would also have an interest in carbon markets. The CFTC has broad authority to share data and information with other federal and state regulatory authorities and would use this authority appropriately to achieve the objectives set out in the statute.

Joseph R. Glace
Vice President and Chief Risk Officer
Exelon Corporation
Responses to Questions for the Hearing Record
November 6, 2009

Questions from Chairman Tom Harkin

1. **a.) Can you break down the costs of the over-the-counter transaction for me?**

The costs vary by transaction. In an over-the-counter (OTC) transaction, the costs are typically far less than the cost of trading on an exchange, particularly for creditworthy companies like Exelon. Exelon's credit rating enables its counterparties to extend to it some amount of unsecured credit. Exelon can also use standby letters of credit or cross-commodity netting through master netting arrangements to provide collateral or minimize a counterparty's exposure to it. Although Exelon typically does not do so, others sometimes offer liens on assets to enable hedging transactions. All of these measures can yield the same level of payment security at a much lower cost than the cost of posting margin on an exchange for a comparable exchange-traded product.

Consider the following example. Assume that in 2009 an electric power supplier wanted to enter into a fixed price power supply agreement with a utility for 300 megawatts of power in 2012 to hedge against the price volatility in the short term or spot market for power and lock in its income stream. Assume further that the market price the supplier gets from the utility is \$50 per megawatt hour. At the power supplier's current credit rating, it is typically extended an unsecured line of credit of about \$20 million. Given the power supplier's unsecured line of credit, it would not have to post any collateral at the time of the deal's execution. It would only have to post when the counterparty's exposure increases above the \$20 million threshold.

In contrast, as is demonstrated in the example below in response to the next question, doing the same transaction on an exchange through a futures contract or through a bilateral transaction that clears on an exchange, could cost the power supplier millions of dollars in up front collateral, even though at the time of the trade, the position creates no exposure for the exchange.

- b.) How much does it cost to conduct business on exchange versus off-exchange?**

The primary cost of conducting business on an exchange, as compared to off-exchange, is the substantial margin requirements mandated for clearing or trading futures contracts on exchanges. Typically an exchange will require an initial margin in the range of five to fifteen percent of the total notional value of

the transaction (the total quantity times the price). If a transaction were required to be cleared on an exchange, the exchange would determine the market value of the position on a daily basis. If the position becomes more valuable (from the exchange's perspective) because market prices have changed since the date of the transaction, the exchange will require the posting of additional "variation" cash margin. In addition to these margin costs, parties trading on an exchange also incur additional costs associated with establishing a credit facility, such as a loan or letter of credit, for the transaction and the interest costs of the required margin.

The following hypothetical attempts to provide a more specific sense of the costs of transacting business on an exchange. Like the example provided in response to question 1(a), assume that in 2009 an electric power supplier seeks to enter into a fixed price power supply agreement with a utility for 300 megawatts of power in 2012 to hedge against the price volatility in the short term or spot market for power and lock in its income stream. Transacting such a deal on an exchange would be costly because the credit line required to do business on the exchange is substantial. The power supplier would first have to meet a 5% initial margin for its hedges on the exchange. Assuming a \$50 per megawatt-hour market price, the power supplier would have to put up \$6.6 million dollars of initial margin and would have to set aside another \$66 million dollars for potential variation margin. Assuming the power supplier has a BBB credit rating, the interest expense on the \$6.6 million could be about 5% annually. The power supplier could thus incur over \$1 million in interest expense on the initial margin. The supplier might also incur about \$1.1 million more in expense to set up a credit facility for the \$72.6 million needed to meet the margin requirement for the deal. These two expenses could add over \$0.80 per megawatt hour in transaction costs. More importantly, if prices moved adversely against the position after the utility entered into the hedge, the margin requirements could increase as would the interest expense. If the adverse price move was 50% during 2009, an additional \$8 million in interest expense could be incurred through 2012, adding another \$3.10 per megawatt hour to the cost of providing the power. So the power supplier ultimately faces a potential of \$3.95 per megawatt hour, or roughly \$10 million, in interest expenses to hedge the deal, which represents about an 8% increase in power costs. In the normal course of business those costs would be passed along to the utility and its customers.

c.) What are the indirect costs associated with wider bid-ask spreads in the over-the counter markets compared to exchange trading?

The indirect costs associated with OTC transactions as compared to exchange traded transactions would be negligible. There are some legal costs associated with negotiating the agreements and addressing potential disputes that could arise. Additionally, administrative and bookkeeping needs associated with managing multiple counterparties would add some cost, but none of these costs are substantial.

d.) How much more would electricity cost your customers if you could only hedge on regulated markets with stricter margin and capital requirements?

In Exelon's view, it is very possible that a requirement that virtually all trading activity occur on organized exchanges, either through clearing or futures contracts, could increase the power prices we charge utilities and other customers we serve by anywhere from five to fifteen percent.

Questions from Senator Chuck Grassley

- 1. While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?**

First, with respect to the age of OTC markets, Exelon notes that OTC derivative transactions have been widely used for well over a quarter of a century. Their use was already so widespread by the early 1980s that the predecessor to the current international Swaps and Derivatives Association first developed its standard trading master agreement for them at that time. Currency swaps were among the first types of derivatives used to hedge risk – in that case, the risk associated with changes in the relative value of currencies. Following the abandonment of the Bretton Woods system for monetary management in the early 1970s, companies doing business internationally needed a way to hedge the risk that the value of transactions would be adversely affected if denominated in foreign currency.

Second, we believe that OTC markets will help keep the cost of compliance with carbon emissions restrictions lower than it would be without them because the cost of over-the-counter instruments will be lower than exchange traded instruments. Margin requirements will be lower, interest expense will be less, and there will be relatively more market liquidity than there otherwise would be.

2. **Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?**

An equivalent level of transparency can be achieved through the establishment of a simple mechanism for the reporting of actual over-the-counter transactions at regular intervals. Exelon and many other energy companies currently report all of their transactions of certain types to industry publications that publish indices, and in many cases, we do this daily. We have systems in place that enable us to do this. The CFTC could impose a requirement for companies to develop an on-line system to enable such reporting. The details need not be included in final legislation; the reporting requirement could be included in the statute and the CFTC could be directed to conduct a rulemaking to determine the appropriate level of reporting, the frequency of reporting, and the measures to be taken to ensure confidentiality.

In our view, this would have a substantial deterrent effect on would-be manipulators. Exelon has endorsed extending the CFTC's existing anti-manipulation authority to over-the-counter derivative transactions. An electronic reporting system would be necessary if that proposal were adopted. The CFTC would need to have access to information about transactions to enable it to fulfill an expanded regulatory oversight and enforcement function.

Questions from Senator John Thune

1. **a.) Can you provide an example of why two market participants would need to use the Over the Counter (OTC) market for a transaction in the carbon market place?**

Assuming cap and trade legislation becomes the law of the land, emitters will either be allotted, or will need to acquire, an allowance for each ton of greenhouse gas emitted from sources that are subject to the law's limitations. Emitters will be subject to a compliance obligation, which they will be able to meet either through allowances they are allotted, allowances they buy, or through reductions in actual greenhouse gas emissions. In addition to buying additional allowances, however, a market for derivatives will likely develop, which market emitters will be able to tap as a means to hedge their longer-term financial risks associated with compliance. The particulars of these hedges will be a function of the details of the cap and trade plan that is ultimately adopted.

These hedges will be developed only if an over-the-counter market for them is permitted to exist and grow. Once such a market develops and evolves, it may be that certain of its products could be traded or cleared on exchanges, just as some products used by the energy industry are now traded or cleared on exchanges. Accordingly, emitters might not absolutely *need* to use over-the-counter derivatives. They would however, benefit greatly from the reduced payment security costs associated with trading on exchanges. We have attempted to detail the additional costs that would be incurred from trading or clearing on exchanges in our answer to question 1(b) from Chairman Harkin above.

b.) In your testimony, you mentioned that forcing these unique transactions onto an exchange would dramatically drive up costs. Could you provide this committee with a better perception of why this requirement would increase costs, and how much would costs increase on account of such a requirement?

Please see our answer to questions 1(b) and 1(d) from Chairman Harkin above.

c.) With regards to these transactions, what specific types of information should be reported to ensure transparency while still maintaining the confidential information of the emitter and trader?

Please see our answer to question 2 from Senator Grassley. In addition, we note that the information that would likely need to be reported would be the basic terms of each transaction, such as the fixed price, the floating price, the quantity swapped, and the term of the transaction. There would undoubtedly be concerns about the confidentiality of the information reported because it would expose each reporting entity's market and trading strategies and other business sensitive information. The CFTC would have to provide a means to ensure that such information is kept confidential, at least for a period of time while it is still sensitive. To ensure confidentiality, rules could provide that only the CFTC and its enforcement staff would have access to the information, and perhaps that the information provided would not be subject to the Freedom of Information Act's (FOIA) disclosure requirements because it would qualify under FOIA Exemption 4¹ that excludes trade secrets and other confidential business information from disclosure. This is the case with information provided to other agencies with enforcement obligations and authority (for example, information provided to the Justice Department pursuant to a Second Request response under the Hart-Scott-Rodino antitrust statute).

¹ 5 U.S.C. § 552(b)(4) (2006).

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Dr. Dave Miller
 September 9, 2009

Chairman Tom Harkin

- 1) In your written testimony, you discussed the challenges of establishing standards for offsets. You also mentioned the costs associated with assuring the value of offset activity and that the cost could become prohibitive. Given your discussion of complicated design protocols and uncertainty about valuing offsets, would you support discounts on offsets as a mechanism to address some of the valuation and verification problems inherent in an offset program? If so, should the offsets be discounted by a standard percentage or should the discount reflect expected leakage or nonperformance?

Response: Discounts that are applied to the scientifically-determined crediting rate are an effective and efficient means of addressing uncertainties involved with quantification of agricultural and forestry offsets. The use of a discount factor can also adjust for systemic offset risk factors such as post-contract reversal risk and non-project specific leakage. Use of a discount in this manner has everyone "paying into" a risk pool that the administrator would manage to cover any unintentional reversals or to make sure the agricultural and forestry offsets are delivering at least the environmental benefits that are being credited.

We would recommend that during the initial crediting period of an offset program that a standard percentage discount be set for each type or class of offsets (i.e. soil sequestration offsets, afforestation offsets, managed forest offsets, etc.) that takes into account these estimated risks. We would recommend that during the initial crediting period that USDA undertake activities to specifically document and quantify the actual risks of contract reversals, leakage and other factors and then adjust the discount factor during the second crediting period based on these findings.

Based on the experience of AgraGate Climate Credits as an aggregator of soil offsets under the protocol of the Chicago Climate Exchange (CCX), we believe the 20% discount factor applied by the CCX is more than sufficient to account for potential post-contract reversals and quantification uncertainties.

Senator Chuck Grassley

- 1) Do you believe that it is possible for the average farmer, in Iowa or elsewhere, to recover his increased input costs, in terms of higher fuel and fertilizer prices for example, that

would be caused by a cap and trade system like in the Waxman-Markey Bill, by selling offsets?

The Waxman-Markey Bill has provisions that would make sequestration offsets from agriculture (and possibly forestry) "term credits." If that is the case, then we think it would be highly unlikely that farmers in Iowa or elsewhere would receive income from carbon offsets. In our opinion, term credits will be so highly discounted by the market since they are not fungible compliance instruments that they will have little value and few, if any farmers would accept participate in a program where what they do is not fully recognized. Waxman-Markey will result in the imposition of significant costs on farmers – higher fertilizer costs, higher fuel costs, and likely higher costs for most of their other inputs due to cost pass-through from manufacturers.

If however, the offset provisions are modified similar to those used by CCX, then we believe that most crop farmers in Iowa and in the primary corn, soybean and wheat growing areas could adopt practices that could generate carbon offsets under such protocols. However, adoption of the practice may be insufficient to generate carbon offsets if the farmer has to make commitments exceeding 5 years and assume liability for reversals that could occur after the farmer no longer controls the land. As the period of commitment required for participation in an offset program is lengthened, the ability of producers to participate in the program will be lessened. At a carbon price of \$10-\$20 per ton CO₂, we expect 10 – 30 percent of farmers in Iowa to participate in the offset program. If carbon prices increase toward \$30 per ton, participation rates could increase towards 50 percent of producers. We believe it will take carbon prices in excess of \$50 per ton to stimulate participation by more than 50 percent of producers in carbon offset programs.

Several studies have been conducted regarding the economic consequences for agriculture of a cap and trade system like the Waxman-Markey Bill, although nearly all of the analyses have assumed offset protocols for agriculture similar to those used by CCX, and not "term credits.". Analysis by Texas A&M Universityⁱ found that the representative farms in the Midwest (especially corn-soybeans farms) were more likely to see increased revenues from the sale of carbon credits from activities such as no-till farming, adoption of energy efficiency practices and other offset protocols that are likely to be developed than other parts of the country. But even in the Midwest, most of the gain reported in the analyses comes from the expectation that higher commodity prices will materialize if production is reduced due to higher input costs and shifting of productive farm land to forestry or other non-food or feed uses. We believe there is substantial uncertainty about the expectations for higher commodity prices. Unilateral land idling policies of the United States during the 1980s did not result in higher commodity prices as nearly every acre of foregone production in the U.S. was replaced by increased production in other countries such as Brazil and Argentina. Unilateral adoption of policies in the U.S. that would result in land-use shifting may have similar results where U.S. farm production declines, but world prices do not respond since the "lost" production is produced elsewhere in the world.

An analysis by the University of Tennesseeⁱⁱ indicates that revenue from carbon offsets alone will be insufficient to fully compensate for increased input costs, but if increases in crop prices are incorporated into the analysis, major feedgrain, oilseed and grain producers will see net gains, in aggregate, from a carbon cap and trade program. Livestock producers are less likely to

see carbon-related income that offsets increased production costs unless there are significant reductions in livestock production. The Tennessee analysis indicates that a cap & trade program like Waxman-Markey may result in a 13 percent reduction in beef production. Clearly the farmers and ranchers who are being forced out of the business due to economic stress will not garner enough income from a carbon program to compensate them for the increased costs. Survivors may eventually be better off, but that assumes consumers will be willing to pay significantly higher prices for meat, milk and other livestock products. Currently, there is no evidence that that is the case.

Participation in carbon offset programs by producers of peanuts, potatoes, cotton, rice, and many other vegetable crops, as well as livestock producers, will be less likely to generate sufficient carbon offset income or increased crop revenues to overcome the increased production costs that they are likely to face.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

Two primary obstacles for agriculture becoming a major source of offsets are the length of contracts that would be required and the potential for liability for reversals after the end of a carbon contract. In Iowa and Illinois, more than 60 percent of crop land is farmed on one-year renewable leases. The non-continuous nature of such leases create a significant obstacle for farm operators who lease land to participate in carbon offset programs that are likely to require multi-year contracts (some suggesting contract lengths of 5 to 10 years for soil sequestration). The second major obstacle is potential liability for reversals that might occur after a farmer no longer controls the land on which the qualifying practice was undertaken. If this liability is open-ended or deemed to be excessive, then there is likely to be less participation by farmers who rent land in the carbon offset program. EPA has expressed concern that offsets from biological sequestration may not be permanent and thus may not meet the standards that the administrator of the carbon offset program might impose. Given these obstacles, it can be understood why EPA analysis showed that the vast majority of offsets would come from afforestation as trees are planted on existing pasture lands and crop lands and that very few offsets would come from production agriculture involved in row-crop production.

Imposition of "term offset" status on credits from agriculture would be a significant obstacle to agriculture becoming a major source of offsets since the likely value of such offsets would be highly discounted in the marketplace and would create little incentive for farmers to participate. Agriculture has great potential to provide carbon credits if the policy is written in a way that is compatible with the operation of commercial farms. But that potential could go unfulfilled if the policy fails to recognize the unique attributes of agriculture and relies on unattainable absolutes.

- 3) Of the sources of ag offsets, one of the most frequently mentioned is shifting to no-till, but the EPA analysis admits that "agricultural soil sequestration does not show significant

supply.” Another option is reducing fertilizer use, but the EPA model showed what any farmer could tell you that this results in a decline in yields. Another often discussed offset possibility would be for farmers to install an anaerobic digester, but those can cost hundreds of thousands of dollars and a federal AgSTAR program report found that anaerobic digesters are feasible for only what amounts to about 1 percent of Iowa farms. How would a typical farmer in Iowa be able to receive any significant benefit from selling carbon offsets?

USDA analysis indicates that soil sequestration on agricultural land has the potential to remove and sequester between 10 to 15 percent of all U.S. carbon emissions. If the rules for carbon offsets require strict permanence, rather than recognizing that soil sequestration, while less than eternal, may have significant duration, then there will be little opportunity for farmers to realize income from offsets. However, if the rules of offsets are structured so that the full potential of soil and forestry sequestration is recognized by the program, then farmers could generate significant income from offsets. The soil offset protocol of the CCX should be a guide for development of workable protocols for agricultural soils and forestry.

- 4) In order for farmers to get paid for sequestering carbon dioxide in the soil, they would have to switch to no-till, but many farmers have already been using no-till for many years where it's possible to do so. Any farmer that was using no-till before the date we establish in law would not be eligible for payments. This could result in two neighboring farmers using no-till where the one who had switched over years ago would not see a dime and the Johnny-come-lately would receive a check for doing the exact same thing that his neighbor had been doing all along. This would surely strike most farmers as fundamentally unfair. What can be done to address the fairness issue?

A couple of points in regards to this questions. First, while a lot of farmers use no-till on soybeans, they may do minimum tillage, rather than no-till, on corn. Our experience would suggest that less than 10 percent of farmers do continuous no-till. Secondly, no-till can sequester carbon for decades. Just because a farmer is already doing no-till, unless they are under a contractual commitment to do continuous no-till for multi-year periods, they could revert to some level of tillage in order to qualify in the future for carbon offsets. We believe that in order to avoid perverse incentives, the legislation should stipulate that for agricultural practices the commencement date of the qualifying practice is the calendar year in which emission sequestration activities are first quantified and verified. Continuation of the no-till activity will prevent the release of carbon that is already sequestered and the recognition of early actions without penalizing the early actor is likely to stimulate even more participation in the emission reduction programs in the future and generate better results for the atmosphere than would otherwise be achieved by denying participation to these early actors.

- 5) We've heard a lot about opportunities for farmers to sell offsets, but it's not always clear how exactly that would work in practice. Since the farmer would actually be selling on a carbon market and offsets would need to be verified and registered, I imagine the process would be a little different from signing up for a FSA program for instance. Could you

walk me through the process a farmer would undertake to receive payment of an offset through let's say USDA, for sake of discussion?

Assuming for this question that USDA is the carbon offset program operator, a likely process for farmers to participate might be as follows:

- 1) USDA establishes a protocol (rules) that defines the activity or activities that would qualify for carbon offsets.
- 2) A farmer would sign a contract to do the practice(s) or activities that qualify.
- 3) This enrollment process would likely include a designation of the land that is being enrolled, and evidence of ownership of the carbon rights
- 4) Either the farmer (or an aggregator representing him) would make arrangements for a USDA-approved third-party verifier to verify that the producer has carried out the compliant practice or activity according to the USDA protocol. (It is possible that this verification could be a statistically-valid, random sample of a pool of participants combined with an annual certification document that the producer would file with USDA.
- 5) USDA would review the certification and verification documents and upon approval, register the offsets in the official registry.
- 6) The registry operator (which might be USDA) would issue a certificate to the producer indicating the quantity and vintage of the issued offset credits.
- 7) The farmer would then either directly market the offset certificate to a regulated emitter who needs offsets, or more likely, would contact a broker or aggregator who would put together larger pools of certificates which would be marketed to those needing offsets (likely on an electronic exchange, for market transparency).

The above description is purely speculative though since nearly all of the details regarding how carbon offsets from agricultural processes would be handled under Waxman-Markey are left up to the administrator or the Secretary to develop and define. Our comments reflect a process that would be based to a degree on the processes now employed by the Chicago Climate Exchange and other voluntary markets.

- 6) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

We believe that market transparency is critical to smooth operation of the carbon offset market and that most, if not all, registered offsets should trade on standardized contracts on regulated exchanges. We believe that OTC contracts that are based on (or reference) standardized, exchange contracts would be useful for locking in forward commitments, and to facilitate financing of dedicated, specific projects where the contract specifies actual delivery of the offset rights. We believe that there should be substantial price and quantity reporting requirements for OTC contracts similar to reporting requirements for prices and quantities in agricultural markets.

- 7) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

We support using the traditional CFTC regulatory mechanisms and requirements to assure transparency in the carbon markets as well as requiring price reporting and transparency for OTC carbon markets.

¹ AFPC Research Paper 09-2, Economic Implications of the EPA Analysis of the CAP and Trade Provisions of H.R. 2454 for U.S. Representative Farms, **August 2009**, Department of Agricultural Economics, Texas A&M University, College Station, Texas

² Some Estimated Impacts of Climate Change Legislation to the Agricultural Sector, A 25x25 sponsored webinar, Burton English, Daniel De la Torre Ugarte, Chad Hellwindkel, Tris West (ORNL), Kim Jensen, and Christopher Clark, University of Tennessee, Knoxville, TN

Senate Committee on Agriculture, Nutrition & Forestry
Global Warming Legislation: Agricultural Producer Perspectives and Trading
Regulation Under a Cap and Trade System
Questions for the record
Mr. Timothy Profeta
September 9, 2009

Chairman Tom Harkin

- 1) You said in your testimony that there is a fundamental trade-off between “Mitigating systemic risk and creating additional cost of posting margin.” It seems that a lot of our legislative choices come down to this type of calculation, over-the-counter transactions where businesses don’t need to put up a lot of cash to do business and exchanges where they expect you to put up some money to back your bets. But if the regulatory system does not deal effectively with systemic risk, such as that posed by OTC trading, are there not costs to that? I’m referring to the costs of using intermediaries like dealer-banks, or volatility, or economic downturns, or taxpayer-funded bailouts.

There are costs embedded in over-the-counter instruments. Cost comparisons typically compare the cash required to post margin for an exchange trade with the fact that OTC contracts may allow purchasers to pledge physical assets as collateral rather than posting cash margin or perhaps not require any collateral at all. By not requiring cash margin, OTC instruments may allow entities to use their cash flows for other purposes. OTC instruments may have transaction costs embedded in the price of the contracts, however.

Events over the past year make it clear that large markets failures can affect broad sections of the economy. Excessive risk-taking in the credit default swap markets, for example, has resulted in significant costs to society, not only through taxpayer-funded bailouts, but also through restricted credit markets and significant loss of value across securities markets. In terms of a carbon market, the cost of large scale market failures could include undermining the nation’s approach to addressing climate change. Congress can take steps to avoid these types of failures in the carbon market by ensuring that market participants properly capitalize financial risks. Reduced leverage, larger capital requirements and prudent margin requirements are all necessary parts of the solution. However, the elimination of regulatory arbitrage is also a key to a stable market, with regulators having sufficient information to evaluate the risks to which market participants are exposed.

As Congress moves forward with climate change legislation, it will have to balance the risks and costs posed by OTC instruments with the flexibility and lower cash requirements that these instruments provide for market participants.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

The evolution of the OTC market over the last ten years is highlighted by the increase in "exotic" derivatives. Plain-vanilla OTC derivatives, such as interest-rate swaps, have been around for approximately thirty years.

There are two arguments for how OTC instruments keep costs low. The first argument is that OTC contracts provide entities with the flexibility to determine the most cost effective means of hedging risk. Entities may choose OTC instruments because the instruments are not available on exchanges, such as long-dated contracts, or they need an instrument that is specifically tailored to their business needs. The second argument is that OTC contracts may allow companies to avoid tying up their cash reserves by posting margin. Exchange-traded products require initial margin and variation margin posted on a daily basis in cash (or near cash, such as government securities). A customized OTC contract can have specific parameters written into it that allows changes in the frequency for variation margin to be posted (i.e., not daily). OTC contracts may also allow companies to assign non-cash collateral as initial margin or, in some circumstances, not post collateral at all.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

There are different levels of transparency in the current commodities markets regulated by the CFTC, depending on the type of commodity and where the commodity trades. While broader market reforms currently under consideration may increase transparency in commodities markets, these efforts are still underway and it is impossible to predict what the final requirements will be. Because Congress would be creating the carbon market *de novo*, the legislation could ensure that the market regulator has jurisdiction over the entire marketplace and can track all transactions involving carbon allowances or associated derivative instruments, regardless of who is involved in the trade and where the trades occur.

Unlike traditional commodities, emission allowances issued pursuant to federal climate legislation will likely have unique serial numbers, allowing regulators to track ownership of the allowances with the proper reporting requirements. The legislation or implementing regulations could achieve transparency in the derivatives markets by requiring reporting from exchanges,

clearing organizations, trade repositories, and intermediaries such as brokers and dealers. If over-the-counter instruments are allowed in the carbon market, the rules could also require reporting directly to the regulator if the transactions are not cleared or reported to trade repositories.

Senator John Thune

- 1) Relative to other commodity markets, how large will the carbon market be? Is it possible to establish unique regulations that will result in efficiency and transparency of such a large carbon market within two years?

The Clean Energy Jobs and American Power Act would create a substantial new carbon market but would not be larger than many existing commodity markets. Economic modeling conducted by the U.S. EPA suggests that the price of emission allowances would likely be around \$13 per allowance in 2015. Just over five billion allowances would be issued that year, resulting in an allowance market worth approximately \$65 billion. As a general rule, commodities trade between 6 and 9 times their underlying value in the futures market. This suggests that the derivatives markets could exceed \$390 billion in the early years. In comparison, the value of global crude oil markets traded on the Intercontinental Exchange (ICE) and NYMEX exceeded \$17 trillion in 2008. Global futures for cotton and sugar trading on ICE reached \$154 billion and \$543 billion in 2008, respectively.

It is possible to create an efficient and transparent regulatory system to oversee trading in the carbon market. The major legislative proposals for regulating the carbon market, including the American Clean Energy and Security Act that passed the U.S. House of Representatives in June of this year and the Carbon Market Oversight Act of 2009, introduced by Senators Diane Feinstein and Olympia Snowe, are founded upon the existing CFTC regulatory model. Both bills adopt many aspects of the Commodity Exchange Act and add specific requirements to address the unique aspects of the carbon market, including some best practices from existing securities regulations. The CFTC would build upon its existing expertise rather than creating an entirely new regulatory system.

- 2) As you stated in your testimony, a cap and trade scheme will create two markets, a cash market that will trade allowances from the current year; and a derivatives market, that will allow the parties to purchase futures, options, and other instruments aimed at creating future rights to allowances. Should both markets be regulated by the CFTC? If so, what are the potential pitfalls of splitting the regulatory responsibility with another agency? If not, what additional resources will the CFTC need to carry out this responsibility within the next couple of years?

The CFTC is well-positioned to regulate both the spot and derivative markets for carbon allowances. The cash and derivative markets will be highly correlated and it would be most efficient to have one regulator with its eyes on the entire carbon market complex, including OTC derivatives. The recent failures in the credit default swaps markets highlight the problems caused by relying on multiple regulators to oversee various aspects of the same market.

Additional pitfalls for splitting regulatory authority include the potential for turf wars and a history of poor cooperation between various government agencies.

Generally, the CFTC will need sufficient resources to oversee the carbon market; the key to good regulation is a well-funded and vigilant regulator. I am not in a position to estimate the additional resources that will be necessary. Chairman Gensler and his staff may be able to provide you with a specific answer.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Frank Rehermann
 September 9, 2009

Chairman Tom Harkin

I am concerned that global warming's impacts – longer droughts and heat waves, increased pests, and increased disease may well be the biggest threat to farmers' abilities to make a profit.

- 1) Have you considered the potential drawbacks of inaction? How global warming will directly impact your industry?

The USA Rice Federation does not oppose responsible efforts to curb greenhouse gas emissions or climate change, including approaches such as increased use of renewable energy sources, nuclear energy, conservation, enhanced efficiencies, and other approaches that would not harm the U.S. economy or cost American jobs. We are deeply concerned that the cap and trade bill emanating from the House and similar approaches would be especially harmful to family farm operations like mine. The pending cap and trade proposal would substantially increase production costs and lower net income, threatening the economic viability of the farm. Meanwhile, I have little confidence that our trading partners will bind their farms and industry to equally rigorous emission reduction requirements, if any at all.

Senator Pat Roberts

- 1) You mention the AFPC study by Texas A&M. The representative rice farms experience lower average annual net cash income and at the same time an increase in annual costs. How does this study affect a producer's relationship with his or her lender? Credit is certainly tight already. Do you expect it to become even tighter if cap and trade legislation were to pass? How does this affect beginning farmers and ranchers?

The impact of pending cap and trade legislation ranges from even tighter margins for some to negative cash flow for others. The effect is to erode a producer's equity position, something lenders look unfavorably on when making lending decisions. For producers in the latter end of the range and especially for small and beginning farmers, the impact of cap and trade legislation could prove decisive in a lender's decision, while producers in the former range are on the bubble. This is why, in our testimony, we urge Congress to authorize the Commodity Credit Corporation to cover any increased production costs.

- 2) If H.R. 2454 were to become law, how would a rice farmer overcome the higher input costs? Would one 'good' year be enough to cover current costs plus addition direct and indirect costs associated with climate change?

We are concerned that some producers simply would not be able to overcome the higher costs and our concern is predicated on a normal or good production year as yield fluctuation from year to year is not as great as it is with respect to many other crops. Production costs and price are principle determinants on how a rice producer fares in a given crop year and the first factor is going to be greatly influenced by this legislation. Note that this is only the production side of the equation. Unlike most other commodities, rice must ordinarily be processed (i.e. milled) before it can be widely marketed in commerce, meaning there will also be increased costs borne by the producer in putting the commodity in the form necessary to market the crop. In fact, generally, rice farmers participating in cooperatives can expect to face a whole other hit in the form of lower patronage refunds, or dividends, on account of the cooperative's increased cost of doing business. And, all of this is predicated on the uncapped treatment of the agricultural sector precluding EPA-imposed performance standards or other prescriptions that the Agency could still impose under other provisions of the bill or the underlying Clean Air Act. There is no effective exemption for production agriculture and necessary processing is not even covered under the definition of agriculture sector. If cap and trade is to go forward, at minimum, there needs to be a clear exemption for agriculture production, including necessary processing.

Senator Chuck Grassley

- 1) I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

Senator, as a farmer, you can appreciate that if there is a clear and responsible way to cut production costs, a farmer will do it. Few stones have been left unturned in this respect. You also know that we are price takers, so we cannot increase the price on the market. One way to offset increased costs associated with cap and trade is through the sequestration or reduction of carbon. However, as I noted in my written and verbal testimony, today that is not an economically viable and proven option for rice farmers. The only choice we are left with is to absorb the increased costs and hope to still make ends meet.

- 2) The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

In rice, we see no economically viable opportunity at present to avail ourselves of the offset program being discussed. We are working to develop some possibilities but we are simply not there yet. The primary objection to the forestation option is that farmers and ranchers are not foresters. Beyond that, even if we were to attempt to go that route, it would seem to me that it would involve an enormous upfront investment without the possibility for any real pay off till years down the road when the trees mature. This is a possibility for large pulp and paper companies but not to farm and ranch families.

- 3) Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Senator, we appreciate your leadership in rejecting what was on the table in the Doha Round negotiations late last year because the agreement meant deep and, in our estimation, unsustainable cuts to U.S. domestic support in exchange for what amounts to illusory concessions from our trading partners. We have no doubt that a similar tact is being taken with respect to global climate change and the curbing of greenhouse gas emissions, as evidenced by recent media reports of comments made by Indian officials. The combination of Doha Round and climate change legislation could very well result in the kind of severe hemorrhaging of American agriculture and the jobs that go with it that we experienced in the manufacturing sector earlier this decade. So, we appreciate the tough stance that you, Chairwoman Lincoln, Ranking Member Chambliss, and others have taken in both regards.

Senator John Thune

- 1) In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

As noted in our response to earlier questions, we are unaware of any proven viable opportunities for rice producers to generate and market offsets in the near future.

In a world of 6.7 billion hungry people, the great majority of whom do not have the means or disposable incomes that we Americans do, we strongly reject the notion that there is greater societal or global benefit to planting trees on our rice-fields than farming them. Ours are some of the most productive acres in the world, and we would rather continue to pursue the more noble purpose of feeding the world as long as we can stay in business.

- 2) As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

Although rice is unable to participate in the agricultural offset program, we believe that U.S. agricultural offset opportunities should not be capped. With respect to international offsets, among other things, it would seem that there would be enforcement issues that could undermine the integrity of the program, so the larger the international program the greater the uncertainty may be relative to the program's effectiveness. However, since

rice farmers are not able to effectively participate in the offset program, we have not closely examined the implications of capping international offsets. We believe the program should be structured such as to increase demand for U.S. offsets and therefore increase the value of such offsets, rather than disadvantage U.S. offsets relative to those in the international market.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System

Questions for the record

Ms. Julie Winkler

September 9, 2009

Chairman Tom Harkin

- 1) One of the more frequent complaints we hear about central counterparty clearing is that the costs associated with clearing are too expensive and that it would tie up capital that could be better invested. Could CME Clearport accept illiquid assets such as real estate or stocks and count that towards margin or capital requirements? Could you net cash and futures positions in a market where the cash and futures transactions are executed on the same platform? What other options are there to mitigate cost concerns of margin and capital requirements without compromising the integrity of the clearinghouse?

ANSWER: *Collateral that is readily convertible to cash is an essential element of the safety of a central counterparty clearing system and the only means to avoid the creation of systemic risk. The central counterparty (CCP) must hold sufficient liquid collateral to enable it to immediately meet the obligations of a clearing member—customer which defaults, since the CCP must immediately fulfill the obligations of the defaulting clearing member to each counterparty. There is no way to do this, without adding debt to the system, if the clearing house is holding illiquid assets, such as real estate, as collateral. The Green Exchange Venture currently uses CME Clearing as its CCP. CME Clearing has never experienced a default in its 110 year-plus history. CME Clearing does accept readily marketable securities, but discounts their value in a manner appropriate to recognize any likely illiquidity at the time that they must be sold to cover a loss.*

CCP's are not in the business of lending to customers. That would simply magnify the risk of operating a CCP and defeat the purpose of centralized clearing. If a customer with real estate assets needs to collateralize a cleared position, she may secure a loan from a bank and use the proceeds of the loan to purchase interest bearing securities, which may be used to collateralize her obligations to the CCP.

It is possible, in certain circumstances, to use a physical allowance to collateralize a derivative position. For example, a trader who is short an allowance futures contract may be able to collateralize his position, in whole or in part, with allowances of similar maturity.

- 2) If legislation establishing greenhouse gas emission allowances and offsets, required that all trading of the allowances, offsets and their derivatives take place on regulated exchanges, and if there is sufficient market interest for allowances 5, 10 or even 20 years in the future, would an exchange be able to offer futures contracts of longer duration? What are the practical considerations that would affect the decision to develop longer-term contracts?

ANSWER: Some futures contracts are long-dated and have adequate liquidity. For example, NYMEX's Natural Gas futures contract extends out 12 years and CME's Eurodollar futures contract extends out 10 years. However, exchange traded derivative contracts of these durations are the exception, not the rule. Price integrity is the critical component to offering long-dated futures contracts as the clearinghouse must be able to determine adequate performance bond coverage for the contracts and protect against default. Each contract month listed in a long-dated futures contract that has open interest will require a daily settlement process to employ the daily mark-to-market functions of the CCP. If legislation created a cap-and-trade program in which allowances were used for compliance over 5, 10, or 20 year periods then long-dated emissions contracts could be designed and offered by exchanges such as the Green Exchange Venture.

However, there could be challenges in generating sufficient liquidity for the long-dated instruments on an exchange. Cap-and-trade participants may be focused on shorter-term compliance obligations involving near-term compliance deadlines that can be satisfied using actual allowances and offset credits that are in their possession or in circulation. The cap-and-trade program could address this by ensuring that there are longer-term vintages of allowances distributed and in circulation. This would provide market participants with a greater certainty about the physical supply of allowances in future years. This may result in greater hedging interest and trading activity in 5, 10 or 20 year carbon futures contracts. Without such certainty of the physical supply of allowances in future years, it is unlikely that adequate liquidity will exist for long-dated exchange-traded contracts.

- 3) I see you are opposed to a transaction fee, such as we've seen in the House-passed climate change legislation. If we were to propose a user fee on these transactions to fund regulatory agencies, what would be the best way to structure it – for example, per exchange member, per transaction, per month, per year?

ANSWER: Funding for market oversight should be generated from more appropriate sources. Most cap-and-trade legislative proposals contemplate an auction for some portion of the allowances. For example, it would take less than one percent of the expected revenues from the auction proposed in the House's American Clean Energy Security Act to fund CFTC's current budget. By tying the funding of oversight resources to allowance auction revenues rather than exchange transactions, all relevant agencies (e.g., USDA, CFTC, EPA) will have resources for all of the elements that are necessary for effective emissions market oversight.

Exchange users pay trading fees which are used to fund exchange operations and the exchange's self regulatory oversight to ensure and compliance with statutory and regulatory requirements. Any additional user fee, based on transactions or targeted at only members of exchanges, will add transaction costs and make less or unregulated trading venues more attractive compared to regulated exchanges. This will impair liquidity and defeat efforts to encourage transparent, regulated trading markets.

Senator Chuck Grassley

- 1) While reviewing the panel's testimony, a theme emerged from a few of the statements. This theme is that customers of power costs will increase if OTC contracts are standardized and required to trade on an exchange. However, OTC contracts are so new, only developed in the last 10 years. And carbon OTC contracts are even more recent than that. Can you explain how an OTC carbon market is so critical to keeping costs low, when up until a few years ago, it didn't even exist?

ANSWER: First, there seems to be a mistaken impression regarding the length of the existence of OTC contracts. Such contracts have actually been utilized for more than 20 years in energy commodities. Second, the reason such contracts came into existence is precisely because they provided innovative, lower costs ways to finance investments; indeed, in some cases, they enabled projects to get financed that otherwise could not have gotten financed at all. Furthermore, they will be the most vital in the early days of any new industry or new industry phase, which will clearly be the scenario in place upon passage of emissions control legislation. This is because the sector will essentially be "inventing" itself--that is, ramping up from a state of de minimis investment in demonstration projects to a full scale commitment to transform the entire societal energy infrastructure. No one yet knows how this will most efficiently be accomplished, so there will be no way to accurately standardize the necessary transactions.

As was stated in my written testimony, the OTC market complements standardized exchange traded products by providing products customized to a regulated entity's emissions and time horizon. Such customization is necessary for successful financing of carbon offset projects, and for structuring long-term hedging transactions that underpin investments in emissions reduction or clean energy technologies. If such OTC contracts are required to efficiently finance such projects, forcing all trading onto exchange-based platforms is likely to increase costs to utility customers.

Exchange cleared transactions require posting of liquid collateral; some entities may be able to secure more flexible terms for collateralizing their obligations in the OTC market. For example, a customer in the OTC market may be allowed to collateralize its obligations on an OTC contract by granting a lien on a physical asset. The ability to collateralize obligations to counterparties by means of liens on physical assets may

benefit power producers or agricultural offset project developers. Lower financing costs for OTC hedging transactions may translate into lower power costs to consumers.

- 2) Many of you have stated the need for additional transparency in the new market for carbon allowances and I agree that this will be critical to ensure the soundness and effectiveness of risk management for both investors and producers. Some of the testimony today has focused on the differences in carbon markets versus traditional agricultural and energy markets. Can anyone give me some specific examples of how to make these markets transparent if not in the same way that traditional CFTC markets are required to display transparency?

ANSWER: We believe that greater transparency should be required of the OTC carbon market and that all carbon-related OTC positions should be reported to the CFTC. This reporting combined with the high level of transparency available through the Green Exchange Venture will provide the additional transparency that is needed for oversight of a U.S. carbon market.

As was stated in my written testimony, CME Group will provide the market and trade surveillance services to the Green Exchange Venture. CME's highly trained regulatory staff will implement audit and compliance programs to monitor existing markets for fraud and manipulation. Green Exchange Venture also has a reliable means to provide transaction data to the CFTC and these are divided into five broad categories: trade data, time and sales, order data, volume and open interest data and reference data. On behalf of the Green Exchange Venture, CME currently reports cleared trade data (pit, electronic, and ex-pit transactions) on a daily basis to the CFTC.

Senate Committee on Agriculture, Nutrition & Forestry
 Global Warming Legislation: Agricultural Producer Perspectives and Trading
 Regulation Under a Cap and Trade System
 Questions for the record
 Mr. Fred Yoder
 September 9, 2009

Chairman Tom Harkin

You've indicated that you think those farmers who have already engaged in practices that reduce greenhouse gas emissions should be rewarded for their early actions.

- 1) Let's take the example of a corn farmer who started to use no-till practices in 2006. How should those practices over the past few years be treated in global warming legislation? And, does it make a difference whether the farmer sold carbon sequestration credits derived from those practices on the Chicago Climate Exchange?

By rewarding early actors, we mean allowing them to participate in a carbon market moving forward, regardless of when those practices began --- perhaps through an "avoided abandonment" carbon credit. For instance, if a grower has used continuous no-till since 2006, he or she should not be disqualified from selling future offsets in a cap and trade system. Congress should avoid establishing policies that encourage growers to till up land for the sole purpose of qualifying for a carbon market. This does not mean receiving compensation for past sequestration. An individual should only be paid for the future offsets that occur as a result of these ongoing actions and not for offsets that occurred in the past. At the same time, if growers had previously participated in CCX or other trading regimes, they would be bound by the existing contract specifications until maturity.

Senator Pat Roberts

In your testimony, you mention "economic analyses have indicated that a robust offset program will significantly reduce the costs of a cap and trade program." Since analysis shows both significant agriculture production cost increases and increased commodity prices due to a reduction in farm land acreage even with an offset program, won't consumers still feel the effects of these higher costs and prices?

To clarify the testimony, a robust offset market will significantly reduce the costs of cap and trade program to American farmers by providing additional revenue, and it would also reduce the impact of the program for the overall economy by providing a low cost mechanism for utility companies and the larger capped sector to meet their emissions targets. At the same time, our analysis indicates that all farmers and corn producers in particular, will face higher costs of production from increased energy costs. In addition to the direct energy costs is the indirect impact of higher fertilizer prices. Agriculture is unique in that farmers are "price takers" and will have very limited ability to pass these

cost increases on to consumers. Several other analyses have indicated that there is a risk of acreage diversions within an offsets program if it is not structured properly. Higher sequestration rates associated with afforestation or planting of perennial grasses could lead to higher payments for these offsets thereby diverting crop ground and pasture out of active production. These acreage shifts would reduce agricultural production, increasing prices for commodity purchasers and ultimately be passed on to consumers as higher food prices. Congress and USDA should provide a robust set of offset projects that virtually all producers could find some way to participate on working farmland. It is a mistake to focus all of our research and protocol development on tillage practices when other valuable project types could be incorporated for row crop agriculture. Policy choices and baseline assumptions in an offsets market will determine how much incentive exists for cropland and rangeland to be planted in trees. Dramatically increasing crop yield trends may also mitigate conversion except for on marginal acres.

Senator Chuck Grassley

I agree with your testimony that farmers can expect to see the cost of fertilizer, fuel, machinery and other inputs to increase under a cap and trade system. I believe this could make our farmers less competitive in a world economy. What types of actions on your farm do you anticipate taking to help offset these increased costs?

I believe if we are going to go down this road of offsets, it is essential to look at current production methods and examine ways we can reduce costs if the agriculture industry is going to continue to thrive. In looking at typical greenhouse gases such as carbon dioxide, methane (28 times more potent than CO₂), and nitrous oxide (300 times more potent than CO₂), it seems to me we need to be looking at how we can reduce nitrous oxide emissions and create an offset credit for doing this. Agronomists tell us we lose at least 30% of all nitrogen applied to soils for growing corn. When we realize that preventing just half of those losses would equate to the equivalent of the mitigation of 7 tons of CO₂ per acre, surely we can develop a science-based and verifiable protocol to establish the creation of an offset credit for virtually all corn producers across the country to participate in. The other concern about our farmers being competitive in a world economy is right on. Unless the rest of the world's agricultural producers are required to follow similar rules for producing feed, food, fuel, and fiber, we will be put in an enormously unfair position of competing. That is why the international process is so critical. We must continue to work with other agriculture groups around the world to garner their acceptance and participation in climate mitigation.

You mention that treatment of early actors, especially those who have adopted conservation tillage practices prior to 2001, should not be penalized in the carbon offset program developed. Do you have recommendations on how to address this issue, in particular for the earliest adaptors as you have highlighted?

The fact of the matter is that each and every crop grown sequesters new carbon. By penalizing the early adaptors of conservation tillage practices, it will encourage

significant reversal of those systems that have not only sequestered considerable carbon but also saved countless tons of topsoil and nutrient runoff. This is basically a policy decision which can easily be addressed by including an offset credit for "avoided abandonment" as mentioned in the Stabenow-Baucus language. This would effectively grandfather all early adopters for tillage practices without a cutoff date.

EPA numbers suggest very high cost increases to use coal. Since the Corn Belt primarily uses coal to provide our energy needs, do you believe that fuel switching will occur? To which types of fuels? What does this mean for our rural communities?

It's undeniable that the cap on existing coal-fire power plants will raise electricity rates for consumers. Research is underway to determine the feasibility of switching fuels at these plants, to include the possibility of including biomass. However, this goes beyond the simple economics of the cost of retrofitting the plant, farm level collection and processing, and transport to the plant. The use of existing crop residue (corn stover, wheat straw, etc.) has to be held to a sustainable level that does not reduce soil tillth. Likewise the introduction of new energy crops (perennial grasses, forestry) will likely compete for existing crop ground reducing crop production and increasing food prices for consumers. At the same time, it is essential for power plants to have access to a plentiful supply of low cost carbon offsets in order to continue to use coal in the electricity generation process. In fact, the energy sector has included the creation of a robust offsets market as one of their major policy objectives in climate legislation. Agriculture offsets can reduce greenhouse gas emissions while simultaneously mitigating increased energy costs for consumers.

The EPA analysis of the House-passed Waxman-Markey Bill showed that the vast majority of domestic offsets would go toward planting trees and forest management and only a small fraction would go toward agriculture. Can you discuss some of the obstacles to agriculture becoming a major source of offsets and if there are ways to overcome them?

First of all, I believe the EPA analysis and the underlying FASOM model to be fundamentally flawed. EPA does not use current yield data for corn and also employs a flawed baseline for soil sequestration. Due to these incorrect assumptions, the FASOM model points to only a minimal opportunity for generating carbon credits on active farmland. It should also be noted that converting land from row crop to forestry requires its own set of investments and infrastructure, so land use decisions will not be based exclusively on the price carbon. Nonetheless, most of the research conducted to date shows that afforestation or perennial grasses sequesters more carbon than most of the proposed agricultural offsets like continuous no-till or increased fertilizer efficiency. For example if afforestation has a SR of 2 MT of CO₂ per acre and continuous no-till is 0.6 MT, a landowner would receive 3 1/3 times more payment for planting trees. At the same time, there are costs barriers to entry in the offset market for row crop agriculture. Our analysis shows that farmers experience costs for adopting a new practice like continuous no-till. There will be new equipment to purchase and in many areas there will be a temporary yield drag with no-till. These costs can be spread out over the life of the equipment and research indicates that the yield drag diminishes as farmers overcome the learning curve; however, there are still areas where continuous no-till is not a viable

production option. This is one of the reasons why enabling farmers to stack credits is so critical. It simply allows growers to gain a larger share of the offset payment while keeping land in agricultural production. These producers will still have the opportunity to adopt other offset practices, many of which have a significantly lower SR than continuous no-till. Then it becomes a question of at a lower SR is the offset payment sufficient to cover other entry costs such as verification and validation.

Farmers' livelihoods depend on their competitiveness in a world economy. While the U.S. remains a strong player in agricultural trade, I believe that moving unilaterally on a climate change bill, without an international agreement, will put all U.S. industries at a competitive disadvantage. Right now, we have no guarantees that farmer's offsets will exceed the indirect costs they will undoubtedly have to shoulder. Please describe what you foresee as the international economic consequences our producers would encounter if a cap and trade system is put into place in the United States, but not elsewhere in the world.

Lack of an international agreement, and more importantly a verifiable international agreement would be detrimental for U.S. agriculture. Farmers in other parts of the world could conceivably capture market share if we adopted legislation that puts our producers at a competitive disadvantage. One policy option is an "on-ramp" that delays implementation of climate legislation until other major countries have adopted similar rules.

Senator John Thune

If under a cap and trade system, ag producers are asked to sign a long-term contract, but only receive benefits of carbon sequestration for a few years or until the soil is saturated with carbon, do you think your members are likely to participate?

Both length of contracts and carbon saturation are both key issues that need to be addressed in either legislation or the final rule making process. One issue that cannot be overlooked regarding contract length is the fact that a majority of a farmers ground is actually leased from the land-owner. Although it is not uncommon for the same farmer to farm a piece of ground for many years, it is rarely done on a multi-year contract. In addition, carbon saturation needs additional research. If the saturation time frame is set too low it is foreseeable that land used as offsets will be forced out of the program just as the largest impacts from cost of production increases are being felt. The alternative under this scenario is limited farmer participation in the early years.

In the early years of a cap and trade system, what types of offset practices do you think will be used first? Planting trees? Conservation tillage?

In the early years, no-till and conservation tillage practices will probably be the first to be considered on working farmland. However, in areas where there is continuous corn grown or where soil temperatures are cooler, widespread no-till may not be practical.

That is why it is imperative we continue to investigate methods to reduce nitrous oxide in raising corn, which could generate offset credits regardless of geography or tillage practice. Virtually every producer could participate in reducing the loss of nitrogen, which is estimated at 30%, by adopting new application technologies and using new stabilizers to keep nitrogen in place, and even reduce the amount needed to apply. Seed companies will soon introduce new biotechnology varieties that can utilize nitrogen much more efficiently and thus reduce amounts applied. Other offset practices such as using cover crops, and applying bio-char would also be attractive for farmers to use in offset projects. If policies offer a broad range of offset practice types, we will see greater acceptance from the agriculture sector and a greater willingness to participate.

Do you believe fertilizer prices will increase under a cap and trade system? If so, how high may fertilizer prices increase? Do you believe we will have a greater reliance on foreign sources of fertilizer?

Assuming the fertilizer manufacturers receive sufficient allowances to cover their increased costs, and they pass these cost savings along to growers in lower cost fertilizer there should be minimal impacts in the early years. However, beginning in 2025 and extended through the remainder of our analysis (2035) we expect significant increases in the cost of fertilizer. Our analysis shows if the price of a MT of CO₂e is \$167.16 in 2035 (EIA), corn growers would see a \$35/acre increase in fertilizer costs. Increased reliance on imported fertilizers will largely depend on two factors. First how many allowances will domestic manufacturers receive and what will they do with them. Second, how will the U.S. treat imports from countries that do not have similar climate change legislation. The U.S. is currently importing a majority of our Nitrogen fertilizer needs. In 2009, approximately 1/3 of the imports came from Canada, which would be assumed to implement similar legislation. The remaining 2/3 of imports comes largely from countries like Trinidad and Tobago, and the Middle East. As an aside, there may be opportunities for some domestic utility companies to offer new sources of fertilizer as a refined byproduct of coal scrubbing if these practices are incentivized with allowances. Recent discussions with a major electricity provider indicated their willingness to dehydrate their waste water and produce a 20% nitrogen solution that could be sold to local farmers. This could supplement our domestic fertilizer production in the future.

In the later years of the House-passed cap and trade bill, "energy intensive trade exposed" industries including the fertilizer industry, no long receive free allowances. What impact will that have on the fertilizer industry and the price of fertilizer? If most early acres of conservation tillage are saturated with carbon at this point, what impact will these two scenarios have on the cost-benefit analysis for feed grain farmers in the Midwest?

Our analysis shows that all farmers will experience cost of production increases (fuel, electricity, natural gas/propane, fertilizer). These cost increases will begin as soon as cap and trade legislation is implemented and grow over time. Our study includes the assumption that the fertilizer allowances will moderate these cost increases until they phase out beginning in 2025. The full impact of fertilizer increases will come into effect starting around 2032 and continue into the future. These factors point to the need for a robust offsets and allowance pool that is beneficial to agriculture. It's important to

emphasize that the program must be broader than just credits for no-till. Our analysis looked primarily at continuous no-till and determined that the ability of farmers to adopt this tillage practice is not universal. Farmers in certain areas particularly northern portions of the Cornbelt, will have lower adoption rates than other growers. Protocols for other sequestration practice types should be developed by USDA to offer opportunities to all growers regardless of geography. Our analysis did not include assumptions concerning carbon saturation, but according to research from Dr. Ratan Lal of the Ohio State University, there is good reason to question some of the published data on saturation levels. His studies indicate soils can hold considerably more carbon than previously indicated. He has seen examples of continuous no-till for many consecutive years where sequestration is still taking place.

How should Congress treat the early actors of conservation practices? For example, South Dakota already had 2.8 million acres in no-till, which would not receive credit under the House-passed climate change bill since these acres were in no-till before 2001. Should these producers be able to participate in the carbon market? If so, how should these acres be treated?

The fact of the matter is that each and every crop grown sequesters new carbon. By penalizing the early adaptors of conservation tillage practices, it will encourage significant reversal of those systems that have not only sequestered considerable carbon but also saved countless tons of topsoil and nutrient runoff. This is basically a policy decision which can easily be addressed by including an offset credit for "avoided abandonment" as mentioned in the Stabenow-Baucus language. This would effectively grandfather all early adopters for conservation tillage practices without a cutoff date. At the same time, these growers would presumably still be able to participate in other offset practices in addition to no-till and stack these credits (fertilizer efficiency, irrigation efficiency, elimination of fallow, etc.).

As many of you know, agriculture or domestic offsets are capped under the House-passed cap and trade bill. Should these offsets be capped under a truly market-based system? Why or why not? Should international offsets be capped?

By artificially limiting participation or access to develop credits, the effectiveness and efficiencies of an open-market product will be skewed. If offsets are capped too low the price will be artificially high and will drive up energy costs for all consumers. However, under HR 2454 there is a robust domestic offsets pool with a cap of 1 billion tons as well as an international cap of 1 billion tons. There would be considerable difficulty to produce more than we would be allowed under this scenario. In fact, the industry would need access to those international credits to keep the markets competitive and to reduce the costs of the cap-and-trade program for the overall economy. The larger concern with international offsets is not capping their levels, but verification. There must be an international method to verify that the purchased offsets abroad are truly sequestering carbon. Without these assurances, offset prices will fall depriving U.S. producers of a fair market return and possibly giving our global agriculture competitors an unfair advantage.

CFTC, USDA FARM CREDIT NOMINATIONS HEARING

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION

SEPTEMBER 30, 2009

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry



Available via the World Wide Web: <http://www.agriculture.senate.gov>

U.S. GOVERNMENT PRINTING OFFICE

62-716 PDF

WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

BLANCHE L. LINCOLN, Arkansas, *Chairman*

| | |
|------------------------------------|---------------------------|
| PATRICK J. LEAHY, Vermont | SAXBY CHAMBLISS, Georgia |
| TOM HARKIN, Iowa | RICHARD G. LUGAR, Indiana |
| KENT CONRAD, North Dakota | THAD COCHRAN, Mississippi |
| MAX BAUCUS, Montana | MITCH McCONNELL, Kentucky |
| DEBBIE A. STABENOW, Michigan | PAT ROBERTS, Kansas |
| E. BENJAMIN NELSON, Nebraska | MIKE JOHANNIS, Nebraska |
| SHERROD BROWN, Ohio | CHARLES E. GRASSLEY, Iowa |
| ROBERT P. CASEY, Jr., Pennsylvania | JOHN THUNE, South Dakota |
| AMY KLOBUCHAR, Minnesota | JOHN CORNYN, Texas |
| MICHAEL BENNET, Colorado | |
| KIRSTEN GILLIBRAND, New York | |

ROBERT HOLIFIELD, *Majority Staff Director*

JESSICA L. WILLIAMS, *Chief Clerk*

MARTHA SCOTT POINDEXTER, *Minority Staff Director*

VERNIE HUBERT, *Minority Chief Counsel*

(11)

CONTENTS

| | Page |
|--|------|
| HEARING(S): | |
| CFTC, USDA Farm Credit Nominations Hearing | 1 |

Wednesday, September 30, 2009

STATEMENTS PRESENTED BY SENATORS

| | |
|--|----|
| Lincoln, Hon. Blanche L., U.S. Senator from the State of Arkansas, Chairman, Committee on Agriculture, Nutrition, and Forestry | 4 |
| Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia | 7 |
| Bennet, Hon. Michael, U.S. Senator from the State of Colorado | 8 |
| Bennett, Hon. Bob, U.S. Senator from the State of Utah | 9 |
| Nelson, Hon. E. Benjamin, U.S. Senator from the State of Nebraska | 10 |

Panel I

| | |
|--|----|
| Chilton, Bartholomew, Nominee to be a Commissioner, Commodity Futures Trading Commission | 11 |
| O'Malia, Scott, Nominee to be a Commissioner, Commodity Futures Trading Commission | 14 |
| Sommers, Jill, Nominee to be a Commissioner, Commodity Futures Trading Commission | 16 |

Panel II

| | |
|---|----|
| Avalos, Edward M., Nominee to be Under Secretary of Agriculture For Marketing and Regulatory Programs and Member of the Board of Directors, Commodity Credit Corporation | 29 |
| Sherman, Harris D., Nominee to be Under Secretary of Agriculture for Natural Resources and Environment and Member of the Board of Directors, Commodity Credit Corporation | 32 |
| Spearman, Kenneth Albert, Nominee to be Member of the Farm Credit Administration Board, Farm Credit Administration | 34 |

APPENDIX

| | |
|--|----|
| PREPARED STATEMENTS: | |
| Cochran, Hon. Thad | 44 |
| Roberts, Hon. Pat Roberts | 47 |
| Avalos, Edward M. | 48 |
| Chilton, Bartholomew | 50 |
| O'Malia, Scott | 56 |
| Sherman, Harris D. | 59 |
| Sommers, Jill | 61 |
| Spearman, Kenneth Albert | 63 |
| DOCUMENT(S) SUBMITTED FOR THE RECORD: | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Edward M. Avalos | 68 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Bartholomew Chilton | 82 |

IV

| | Page |
|--|---------|
| DOCUMENTS SUBMITTED FOR THE RECORD—Continued | |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Scott O'Malia | 100 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Harris D. Sherman | 137 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Jill Sommers | 178 |
| Committee questionnaire and Office of Government Ethics Executive Branch Personnel Public Financial Disclosure Report filed by Kenneth Albert Spearman | 193 |
| Various organizations, letters of support and endorsement of Scott O'Malia to be a Commissioner of the Commodity Futures Trading Commission | 213-215 |
| Various organizations, letters of support and endorsement of Harris D. Sherman to be Under Secretary of Agriculture for Natural Resources and Environment and Member of the Board of Directors, Commodity Credit Corporation | 216-224 |
| QUESTION AND ANSWER: | |
| Lincoln, Hon. Blanche L.: | |
| Written questions for Bartholomew Chilton | 226 |
| Written questions for Jill Sommers | 226 |
| Additional questions for Edward Avalos | 228 |
| Barrasso, Hon. John: | |
| Written questions for Harris Sherman | 229 |
| Baucus, Hon. Max: | |
| Written questions for Harris Sherman | 231 |
| Written questions for Bartholomew Chilton | 232 |
| Written questions for Jill Sommers | 232 |
| Written questions for Scott O'Malia | 232 |
| Cantwell, Hon. Maria: | |
| Written questions for Bartholomew Chilton | 233 |
| Written questions for Scott O'Malia | 233 |
| Written questions for Jill Sommers | 233 |
| Chambliss, Hon. Saxby: | |
| Written questions for Harris Sherman | 235 |
| Written questions for Edward Avalos | 236 |
| Cochran, Hon. Thad: | |
| Written questions for Edward Avalos | 238 |
| Grassley, Hon. Charles E.: | |
| Written questions for Bartholomew Chilton | 239 |
| Written questions for Jill Sommers | 239 |
| Written questions for Scott O'Malia | 239 |
| Written questions for Edward Avalos | 239 |
| Written questions for Kenneth A. Spearman | 239 |
| Harkin, Hon. Tom: | |
| Written questions for Harris Sherman | 241 |
| Written questions for Edward Avalos | 242 |
| Written questions for Kenneth Spearman | 244 |
| Klohuchar, Hon. Amy: | |
| Written questions for Bartholomew Chilton | 245 |
| Written questions for Jill Sommers | 245 |
| Written questions for Scott O'Malia | 245 |
| Written questions for Edward Avalos | 245 |
| Roberts, Hon. Pat: | |
| Written questions for Jill Sommers | 247 |
| Written questions for Bartholomew Chilton | 247 |
| Written questions for Scott O'Malia | 247 |
| Written questions for Edward Avalos | 247 |
| Stabenow, Hon. Debbie: | |
| Written questions for Edward Avalos | 248 |
| Written questions for Harris Sherman | 248 |
| Avalos, Edward M.: | |
| Written response to questions from Hon. Blanche L. Lincoln | 249 |
| Written response to questions from Hon. Saxby Chambliss | 252 |

| | Page |
|--|------|
| Avalos, Edward M.—Continued | |
| Written response to questions from Hon. Tom Harkin | 256 |
| Written response to questions from Hon. Debbie Stabenow | 259 |
| Written response to questions from Hon. Amy Klobuchar | 260 |
| Written response to questions from Hon. Pat Roberts | 261 |
| Written response to questions from Hon. Thad Cochran | 261 |
| Written response to questions from Hon. Charles E. Grassley | 262 |
| Chilton, Bartholomew: | |
| Written response to questions from Hon. Blanche L. Lincoln | 264 |
| Written response to questions from Hon. Max Baucus | 264 |
| Written response to questions from Hon. Pat Roberts | 265 |
| Written response to questions from Hon. Charles E. Grassley | 265 |
| Written response to questions from Hon. Amy Klobuchar | 266 |
| Written response to questions from Hon. Maria Cantwell | 267 |
| O'Malia, Scott: | |
| Written response to questions from Hon. Charles E. Grassley | 272 |
| Written response to questions from Hon. Pat Roberts | 273 |
| Written response to questions from Hon. Max Baucus | 273 |
| Written response to questions from Hon. Amy Klobuchar | 274 |
| Written response to questions from Hon. Maria Cantwell | 274 |
| Sherman, Harris D.: | |
| Written response to questions from Hon. Saxby Chambliss | 278 |
| Written response to questions from Hon. Tom Harkin | 280 |
| Written response to questions from Hon. Max Baucus | 282 |
| Written response to questions from Hon. Debbie Stabenow | 283 |
| Written response to questions from Hon. John Barrasso | 286 |
| Written response to additional questions from Hon. Saxby Chambliss | 290 |
| Sommers, Jill: | |
| Written response to questions from Hon. Maria Cantwell | 293 |
| Written response to questions from Hon. Max Baucus | 297 |
| Written response to questions from Hon. Charles E. Grassley | 297 |
| Written response to questions from Hon. Pat Roberts | 299 |
| Written response to questions from Hon. Amy Klobuchar | 300 |
| Written response to questions from Hon. Blanche L. Lincoln | 300 |
| Spearman, Kenneth Albert: | |
| Written response to questions from Hon. Charles E. Grassley | 301 |
| Written response to questions from Hon. Tom Harkin | 301 |

CFTC, USDA FARM CREDIT NOMINATIONS HEARING

Wednesday, September 30, 2009

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
Washington, DC

The Committee met, pursuant to notice, at 9:50 a.m., in room 328A, Russell Senate Office Building, Hon. Blanche Lincoln, chairman of the Committee, presiding.

Present: Senators Lincoln, Harkin, Leahy, Klobuchar, Nelson, Chambliss, Lugar, Cochran and Thune.

Senator HARKIN. First I would just like to say that this is a kind of a bittersweet moment for me. I have been honored to chair this Committee and I have been honored to be on it for 25 years now and then 10 in the House. It has just been a great pleasure and honor to be able to be the chair of this wonderful Committee and I want to thank all of the members of the Committee for the great cooperation that you have given me in the past and for especially in the development of the last Farm Bill.

I especially want to thank Saxby Chambliss for a great working relationship, both personally and among our staff, and I cannot thank you enough for all that we did together to work together to get a really great Farm Bill through and I want to thank you for that.

However, I must say that my sadness in leaving the chairmanship is more than compensated by the knowledge that the person taking over the chair is someone that is devoted, devoted to the well-being of our family farmers, is devoted to the economic vitality of our rural communities and, of course, to the nutrition of our children.

And so I am honored to be able to turn over the gavel this morning to Senator Lincoln. I am cognizant of the fact that this is indeed an historic moment. No woman has ever chaired this Committee and this will also be the first Arkansan to ever chair the Agriculture Committee.

So it is with great pleasure and great pride to be able to give the gavel now to you, Senator Lincoln of Arkansas, and we are proud to call you our chairman.

[Applause.]

Chairman LINCOLN. Thank you. Thank you all so much for such an incredible warm welcome to this chairmanship. I am enormously grateful to all of my colleagues for their confidence that they placed in me in the ability to run this Committee and I am

so indebted to each and every one of them for the unbelievable devotion that they give to this Committee.

I know with that kind of devotion, hard work and friendship, we are going to do great things in the Senate Agriculture Committee. So thank you so much, Chairman Harkin, and to all the former chairmen who are here, which are a lot. So I am very grateful and thanks to all of you all for participating in my first hearing, which I am delighted to be a part of.

Senator CHAMBLISS. Madam Chairman, before you take off on your first official business, let me say first of all to my good friend Tom Harkin, I appreciate those kind comments. It has been a real pleasure to work with you, Tom. We have had a great working relationship and as you say, our staffs have worked extremely well together and we have been through some difficult times together trying to look after American farmers and ranchers.

Under your leadership, I think we have accomplished an awful lot. We will still call you Mr. Chairman, but it will just be in a little different capacity there. But we look forward to having you continue on this Committee and you are exactly right that handing off the gavel to Blanche Lincoln has to be a pleasure for you and certainly a pleasure for me.

Blanche and I worked on so many issues together, both on the Ag Committee and off the Ag Committee. When I sit down with her, I do not need an interpreter. We seem to both speak slowly enough that we can understand each other, coming from the same part of the world. She, obviously having grown up on a family farm, knows and understands and has a great appreciation for the difficulties that farmers and ranchers are going through right now.

Her leadership is going to pick up right where you left off, Tom, and we are not going to miss a beat. She is such a great friend, a great leader. It is going to be a lot of fun to have a chance to work with you Blanche, so congratulations to you. Your colleagues on the Democratic side have made a wise choice in bringing you forward.

Gosh, we are going to have to get a wide angle lens, sure enough, to get all of these former chairmen that are in this room now and on this Committee in any photograph. I think that speaks well for the Committee.

Chairman LINCOLN. It does.

Senator CHAMBLISS. We look forward to your leadership.

Chairman LINCOLN. Thank you.

Senator CHAMBLISS. Congratulations.

Senator LEAHY. Madam Chairman.

Chairman LINCOLN. Absolutely.

Senator LEAHY. If I could just make—as one who has served on this Committee now for 35 years, I am delighted to see you here. You are a true daughter of rural America and for those of us who were born and raised in rural America, it means a lot. It is more than just particular commodities, but it is what it means for all of rural America and the need for us to have you here.

I do want to commend both Tom Harkin and Saxby Chambliss for the way they have switched hats back and forth and the way they have run this Committee in a bipartisan, often non-partisan fashion, and that means a lot. Dick Lugar and I did that. As both

chairman and ranking member, we had the opportunity, both of us, to serve in both capacities and be able to work out most things. I think it is because we were able—I wish we could do that in all committees. Not thinking of any one in particular, but the fact that we were able to work things out and you have that ability.

Thad Cochran, the same way, has chaired this Committee. Maybe we should have a special chairman pin or former chairman pin, because we are all here.

Chairman LINCOLN. We will work on that.

Senator LEAHY. I will tell one very quick story, which Senator Lugar knows. When we were both brand new members and sitting way, way down at the end, and former chairman, Herman Talmadge, and Jim Eastland were sitting up here and Senator Eastland brought up some little old amendment, it was about this thick, and just hands it to Talmadge and says, Talmadge says, well without objections, it is accepted.

And I said, wait a minute, could I ask what is in that? The two of them pulled their cigars out of their mouth, looked way down where Lugar and I are sitting. Dick and I are there. They were trying to figure out whether it was Dick Lugar said it or I said it. Either way, they did not know who the heck either one of us were. Talmadge just says, we are adjourned.

[Laughter.]

Senator LEAHY. You will be a different type of chair.

Chairman LINCOLN. I promise.

Senator LEAHY. Thank you and I will go down to Judiciary.

Chairman LINCOLN. Well, thank you, Senator Leahy.

Senator LUGAR. Madam Chairman, if I am just a moment spurred on by Senator Leahy's comments about the two of us sitting at the end of the table, the table then extended almost all the way to the door. As I recall, those who are now sitting in the chairs in the way were on the sidelines in some fashion.

There was mention of smoke. As a matter of fact, the chairman and Senator Eastland were engulfed in smoke so that we could hardly see their faces in the midst, a change in culture during the period of this thing.

Chairman LINCOLN. We are growing and changing.

Senator LUGAR. Yes. We appreciate your coming to the chairmanship very much.

Chairman LINCOLN. Thank you.

Senator LUGAR. We look forward to working with you.

Chairman LINCOLN. Absolutely. We do.

Senator KLOBUCHAR. Madam Chair?

Chairman LINCOLN. Yes?

Senator KLOBUCHAR. If I could just on behalf of the women in the Senate, we are so excited about you taking this new position. I was thinking of all those girls in 4-H showing up at our state fair and all those farming women out there. You have really set a new standard and a new mentor for people who farm and women who farm.

So I wanted to just say that, and I will miss making Iowa jokes to the chairman. I can't. You know, Minnesota, we like to do that.

Chairman LINCOLN. But Arkansas is so much more colorful.

[Laughter.]

Senator KLOBUCHAR. Yeah, I am sure there are no Arkansas jokes that I can come up with. I do know Minnesota, Arkansas are No. 1 and three for turkeys in the country.

Chairman LINCOLN. There you go.

Senator KLOBUCHAR. No one should make turkey jokes. But congratulations again and thank you for your chairmanship, Senator Harkin.

**STATEMENT OF HON. BLANCHE L. LINCOLN, U.S. SENATOR
FROM THE STATE OF ARKANSAS, CHAIRMAN, COMMITTEE
ON AGRICULTURE, NUTRITION, AND FORESTRY**

Chairman LINCOLN. Well thank you all and I am going to call the Committee to order here. The Committee on Agriculture, Nutrition and Forestry will come to order.

Just a special thanks to all of you all and would hope you would allow me to begin on a personal note since this is my first opportunity to officially chair the Committee. It is a tremendous honor to serve as chairman of this Committee and I will endeavor to be the type of steward of this position that the American people and the people of Arkansas deserve. With all of your help, I know I can accomplish that.

As all of you know, the Senate Agriculture Committee does have a well earned and a time-honored reputation for bipartisanship and for working together to promote policies that are born not out of partisanship, but out of consensus as to what policies are proven to work. I could not ask for a better partner than my ranking member here, Saxby Chambliss.

I have the privilege and benefit of serving beside five previous chairmen of this Committee and one previous chairman of the House Agriculture Committee—I will not forget my good buddy Pat Roberts who I had to beg to get on the House Ag Committee and he finally let me on—each of whom have served with great distinction and from whom we have learned a tremendous amount.

Also among our Committee's membership, I count four chairmen, three ranking members of our very important Senate committees, as well as a former secretary of Agriculture and the Senate Republican leader, each of whom adds to the collective experience, strength and wisdom of this great panel.

So let me always say that I truly appreciate the regional diversity that is reflected on this Committee and the unique areas of expertise and interest possessed by each of our members on the Ag Committee. Despite significant policy challenges that we have faced over the years, and even differences of opinion now and again, this Committee has always pulled together and risen to the occasion.

In short, I am very, very proud of each member's contribution to this Committee and I appreciate what each of you all will bring to the table as we move forward on so many critical issues. I am really looking forward to working with each of you all. We have a lot of things on our plate and promoting economic opportunity and jobs in rural America in these economic times, we have great opportunity.

My dad always said, when you have tremendous challenges, look hard because you will find the opportunities. We have opportunities in meeting the nutritious needs of our school children and el-

derly and low-income families, again, particularly in these economic times and continuing to build our successful resource conservation efforts, which we know and many of us have experienced and realized whether it is on our farms or without a doubt in working with your farmers and ranchers across the country.

We have the opportunity of enhancing America's energy independence and ensuring that the men and women who have clothed and fed this nation in a manner that is unrivaled in history continue to do what they do best, and that we can reinforce them and we can empower them to continue to do that and I look forward to it.

In this last regard, I would like to quote our late President John F. Kennedy who said, our farmers deserve praise, not condemnation and their efficiency should be cause for gratitude, not something for which they are penalized. With 6.8 billion people sharing this world that we live in today, compared to the roughly three million in 1960, President Kennedy's words ring truer today than ever before.

I know and you all know that sometimes the Ag Committee is not the most glamorous committee on Capitol Hill, but we have a tremendous responsibility and opportunity to really reflect to the American people and the world the hard working men and women, their families, across this great country that do such a tremendous job.

So whether you are from Iowa or Arkansas, Georgia or Vermont, California or Idaho, if you work to feed and clothe this nation and those around the world, all across the globe, this chairman and this Committee are firmly on your side. And I know that the ranking member of the Committee, my good friend, Saxby Chambliss, shares these goals and sentiments and I could not have a greater friend or a more respected Senate colleague than my partner on this Committee and I am grateful to you, Senator Chambliss, for everything you and your staff do. I look forward to so much moving forward and getting started on the business of the Committee.

We are going to have a good time. We will work hard. We will play hard and we will get things accomplished and I am grateful to you for your friendship and help.

So now, moving on to the purpose of this hearing. We have all had a great stroll down memory lane and we are going to allow the chairman to move to his new chairmanship.

Senator HARKIN. Madam Chairman, this also is my first day to chair my new committee, so I beg your leave. I have to leave to go chair my committee.

Chairman LINCOLN. Well good luck to you and thank you again, Mr. Chairman.

Senator HARKIN. Congratulations.

Chairman LINCOLN. Absolutely. So now we will move on to the purpose, as we say our good byes here, to the hearing at hand.

Today the Committee is meeting to consider six nominations to the USDA, the CFTC, the Farm Credit Administration, and specifically, we consider two nominees for the U.S. Department of Agriculture, Mr. Harris Sherman and Mr. Edward Avalos. Sorry, got to get that one right.

Mr. Sherman has served as executive director of the Colorado Department of Natural Resources for Gov. Bill Ritter and Richard Lamm. In this capacity, Mr. Sherman gained experience working on policies that he would be responsible for if confirmed as the under secretary for Natural Resources and Environment, including management of the Forest Service and the Natural Resources Conservation Service.

Mr. Avalos—help me with that—Avalos has been nominated to serve as the under secretary of Marketing and Regulatory Programs. If confirmed, his mission would touch upon virtually all of American agriculture. The three agencies under his jurisdiction, the Animal and Plant Health Inspection Service, the Grain Inspection Packers and Stockyards Administration, and the Agricultural Marketing Service have broad ranging and important responsibilities within the department.

Mr. Avalos was raised on a family farm in New Mexico, where a variety of specialty crops are grown, including chili peppers, pecans, onions, as well as staple crops like cotton and wheat. His career in agriculture includes 29 years of service at the New Mexico Department of Agriculture, where he successfully worked to implement trade and promotion initiatives aimed at increasing U.S. farm exports. Mr. Sherman and Mr. Avalos are also nominated to serve as members of the board of directors of the Commodity Credit Corporation.

We also meet to consider three nominees to the Commodity Futures Trading Commission, Bart Chilton, Jill Sommers and Scott O'Malia. The CFTC is tasked with regulating commodities futures and options markets dealing with everything from cotton futures to financial derivatives.

CFTC polices the markets that affect everything from the food we eat to the gas that we put in our car to the loans we borrow at our local banks. The CFTC protects market participation from fraud, manipulation and other abuses while making certain that the markets are fully functioning.

Congress, and in particular, this Committee, will soon consider financial regulatory reform and the CFTC will have a front and center role in this effort. In light of this, I am pleased that the Committee is moving as expeditiously as possible to consider these three nominees who bring years of experience, knowledge and diverse perspectives to the Commission.

The Commission and the staff at the CFTC face significant challenges and a heavy workload in the coming months, so it is vital to have this highly qualified team on the job.

Finally, we consider the nomination of Kenneth Spearman for the Farm Credit Administration Board. The Farm Credit Administration is responsible for regulating and examining the banks, the associations and related entities of the Farm Credit System and Farmer Mac. In 2007, Farm Credit System held about 34 percent of the farm sector's total debt, as much—such who serve on that board play an extremely important role in ensuring the continued availability of stable and adequate credit in farm country all across the nation.

Mr. Spearman brings a wealth of experience to the Farm Credit Administration Board. His work in cooperative banking and on fi-

nancial policy issues over the last 28 years will be an invaluable asset to the Farm Credit Administration. Mr. Spearman is nominated for a term that expires next year and for a full 6-year term that expires in May of 2016.

I look forward to the statements of the nominees and their answers to the questions that members of this Committee may have. I would now like to yield to the ranking member, Senator Chambliss, for any statement that he may have and then we will have introductions from other senators.

STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM THE STATE OF GEORGIA

Senator CHAMBLISS. Well thank you very much, Madam Chairman, and boy, it has a great ring to it, Madam Chairman. Again, I want to congratulate you on taking the gavel, just to let you know that you have great friends on this side of the table, and as Senator Leahy said, we have always had a bipartisan committee that is going to get even stronger as we go through the final implementation of the current Farm Bill and look forward to working on the next one as we are already approaching that.

I think we would be a little remiss if on this side we did not recognize the great work that the staff of Senator Harkin has done. And to Mark and Susan, thank you all for your great work, your great cooperation and your commitment to agriculture across the country, and Madam Chairman, to you for bringing Robert Holifield back to the Committee. We are very pleased to have him back, having worked very closely with Robert on the Farm Bill last year. He brings a great wealth of knowledge not just there, but I just saw Chairman Gensler a minute ago, who has come to show his generous support for these nominees.

I know he hates to lose Robert at CFTC, but if we move forward to financial reform, this Committee is going to play an integral role there and Robert has a very strong background that he can bring to the table now to help us. So Robert, we are pleased to have you here as a staff director under Chairman Lincoln. It has a great ring.

Madam Chairman, thank you for holding this important hearing and to consider these nominations pending before the Ag Committee. As we seek to reform our financial system, address the ongoing credit crisis, and have the recently enacted Farm Bill properly implemented, it is vital that we have good leadership in place at the Commodities Futures Trading Commission, the Department of Agriculture, and the Farm Credit Administration.

Commissioners Jill Sommers and Bart Chilton are no strangers to the Ag Committee. Both were previously nominated by President George W. Bush and confirmed by the Senate. President Obama recognized their commitment to ensuring that our commodity markets function properly and the need to keep them in the trenches during this critical time.

I would also like to welcome Scott O'Malia to the Committee. It has been far too long since the Commission was fully seated and Senate confirmed. We must seek to have all three of these nominees confirmed in a timely manner so that all five commissioners can get to work on the important task that the American public ex-

pects them to tackle. The chairman and I were visiting earlier. I am not sure when was the last time we had five full-fledged Senate confirmed commissioners, so this will be an important historical monumental achievement here.

Speaking of tasks, the Food Conservation Energy Act of 2008 was an enormous undertaking by Congress and was enacted over a year ago. It expires in 2012 and yet there are a number of provisions yet to be implemented. The Marketing and Regulatory Programs' mission area at USDA covers many of these provisions. Mr. Avalos, as under secretary, you will oversee a very diverse portfolio at USDA, including plant and animal health, marketing programs and commodity procurement, enforcement of grain standards and fair practices in our meat and livestock industry.

While each of these missions is distinct, they are important to protecting our producers and expanding markets for their products. I trust your long experience with both the Texas and New Mexico Departments of Agriculture will make you a true asset in this role.

Mr. Sherman, you will have a very big job managing our national forests and grasslands, but you will also oversee USDA's programs and activities that promote private land stewardship and conservation. These are the programs that help producers help the land. I look forward to working with you to see that the Farm Bill conservation programs are implemented as Congress intended and are working for producers.

Though there is a pain in agriculture, it generally has not suffered as much as other parts of our economy over the past year. I believe this was due in large part to the sound financial management adopted by producers and their lenders, including the Farm Credit System, over the past 20 years. I hope and expect that will continue into the future and Mr. Spearman, in your role, when confirmed as a member of the board of the Farm Credit Administration, it will be your job to help see that this happens. With your experience in agriculture, accounting and finance, President Obama has found an excellent candidate for the board of the Farm Credit Administration. I am pleased that you have agreed to serve in that position.

Again, I want to thank Chairman Lincoln for making these nominations her first priority and I look forward to a speedy hearing and confirmation of all of these nominees. Thank you.

Chairman LINCOLN. Thank you, Senator Chambliss. We have some guests that are here to introduce some of our nominees and Senator Bennet, I would like to turn to you first since you are here to introduce Mr. Sherman. We are going to do all the introductions first and then we will bring everybody up, because I know that the other senators have other places to go.

Senator BENNETT. Is it you?

**STATEMENT OF HON. MICHAEL BENNET, U.S. SENATOR FROM
THE STATE OF COLORADO**

Senator BENNET. It is me, unless you know Harris Sherman too, in which case, it is better with one T.

Well Madam Chair, let me just say first, congratulations on assuming the chairmanship. I had the good sense, as you know, my

colleagues, you may not know, to marry a woman from Eastern Arkansas, from—

Chairman LINCOLN. That is true.

Senator BENNET [continuing]. The next town over from you. She sounds a lot like you, but she is not the chairman of the Agriculture Committee. But I will say—

Chairman LINCOLN. She is chairman at home though, isn't she?

Senator BENNET. She is. She is, particularly because we have three daughters. But I know how proud everybody back home must feel about that. I know how proud Susan and her folks are of this and so from them, let me say congratulations.

Chairman LINCOLN. Thank you.

Senator BENNET. It is my pleasure today to introduce Harris Sherman and speak in support of his nomination to be under secretary of Natural Resources and Environment at the department. I would also like to welcome his daughter Jessa, who is here today, his sister Barbara Kailey, his brother David Sherman and his niece Shawn Kailey Reagan, who are all here today.

I have known Sherman since 2003, when he was serving as a commissioner on the Denver Water Board. Today Harris serves as executive director of the Colorado Department of Natural Resources and is a member of Governor Ritter's cabinet. As director, he oversees Colorado's energy, water, wildlife, parks and state lands programs. Through the years, I can tell you that Harris has demonstrated an ability to solve difficult problems and balance competing interests regardless of the politics.

If confirmed, his experience making hard decisions as chairman of the Colorado Water Quality Control Commission, chair of the Colorado Mined Land Reclamation Board and chair of the Denver Regional Air Quality Council—There is not much left in Colorado by the way—as well as his work with several non-profit land organizations will prove important as the Nation faces some of the most challenging natural resource issues in decades.

I also want to note that Harris will be charged with overseeing the U.S. Forest Service and the Natural Resources Conservation Service. We know that forest and agriculture are particularly vulnerable to the hazards of climate change and we have seen it in Colorado. In Harris, I know Congress will have a willing partner as we move forward with a pragmatic agenda for protecting our forests and agricultural sector from this severe threat.

Harris has been an invaluable asset to Colorado and made contributions to our state we will never forget. We are glad to share his talents with the rest of the country and I proudly introduce him to the Committee. Thank you, Madam Chair.

Chairman LINCOLN. Thank you, Senator Bennet.

Senator BENNET. Congratulations, Harris.

Chairman LINCOLN. Now the other Senator Bennett, from Utah, as a guest here. I think you wanted to introduce Mr. O'Malia.

STATEMENT OF HON. BOB BENNETT, U.S. SENATOR FROM THE STATE OF UTAH

Senator BENNETT. Thank you very much, Madam Chairman, and we go from one T to two. Whether that is progress or not, I do not—unlike those who talk about a long experience with the person

they are introducing, my relationship with Scott has been relatively brief. We became acquainted just a year ago.

He was nominated for this position in the previous administration and his nomination was blocked by a senator who had a problem not with him, but another problem, and used his nomination as the way to express distress over what the administration was doing. As a consequence of that, when I took over Senator Domenici's slot as the ranking member on the Energy and Water Subcommittee of Appropriations, I inherited Scott.

I am thinking of putting a hold on this nomination myself in an effort to hang on to him because I have found that this young man has an intellectual capacity to grasp a problem, understand it, and then just as importantly, explain it to someone who is a little less qualified to understand the particulars, like myself. He has been an absolutely invaluable member of the staff at the Energy and Water Subcommittee, understanding all of these issues tremendously, high level of energy and activity. There is nothing you can ask him to do that he does not dig into very, very vigorously and very, very well.

I think he will do a superb job at the Commodity Futures Trading Commission. But I will reluctantly give him up to recognize that there comes a time in everybody's career when they need to move forward. I can recommend him absolutely without any reservation as a dedicated public servant with intelligence, integrity and energy that will do a superb job wherever it is he goes.

So I am honored that he has asked me to make this recommendation and I assure the Committee that voting for Scott, and will assure the Senate, that voting for Scott for this assignment is something that we will look back on with great pride and sense of satisfaction as he proves his capacity in whatever assignment he might ultimately get. He has my unqualified endorsement.

Chairman LINCOLN. Thank you Senator Bennett. Senator Cochran, did you—

Senator COCHRAN. Madam Chairman, thank you very much. I have a statement supporting the nomination of Scott O'Malia, which I would ask to be printed in the record. I enthusiastically, as Senator Bennett did, endorse his nomination and urge the Senate to confirm him at the earliest possible time.

Chairman LINCOLN. Great. Thank you. Without objection, we will enter that in the record.

[The prepared statement of Hon. Thad Cochran can be found on page 44 in the appendix.]

Chairman LINCOLN. Senator Nelson is going to join you all over on this side. It is OK. Wherever. We are one big happy family over here.

**STATEMENT OF HON. E. BENJAMIN NELSON, U.S. SENATOR
FROM THE STATE OF NEBRASKA**

Senator NELSON. Thank you, Madam Chair, and I want to introduce Ken Spearman. Where is he? I just walked in. There he is.

Chairman LINCOLN. He is in the back.

Senator NELSON. He is the president's nominee to the Farm Credit Administration Board and his wife, Maria is here. Where is

Maria? Over here. They live in Winter Haven, Florida and that is right in the heart of Florida's citrus belt.

The Farm Credit Administration is obviously vital to your agriculture in this country and it is the largest source of credit to farmers and its effective functioning is crucial to our economic health. You all know this. Given his unique background and experience, he is especially suited for this position. He has been a 28-year veteran of the citrus industry and he serves as a director on the AgFirst Farm Credit Bank, so he is very well versed in banking and finance policy issues.

I think we ought to point out that he is a veteran. He is a Vietnam veteran. He served in Vietnam. Clearly Ken has been involved in a lot of civic and social programs, including tutoring in an adult literacy program, and has been chairman of the board of the Lake Wales Medical Center. I just want to bring all of this to the attention—obviously this is going to be unanimous by acclamation, but I wanted to say my two bits for him, and Madam Chairman, I am going back to the committee meeting that you are missing right now.

[Laughter.]

Chairman LINCOLN. I'm hearing regularly from them. Thank you, Senator Nelson. We appreciate it. Appreciate all the members here in support of our nominees.

To begin this, now we address at hand the business of the day, and if I may, I would like to ask all of you all if you would stand to take an oath.

Raise your right hand. Do you swear to tell the truth, the whole truth and nothing but the truth?

Mr. CHILTON. I do.

Mr. O'MALIA. I do.

Ms. SOMMERS. I do.

Chairman LINCOLN. Great. Again, a mandatory question for you all, do you agree that if confirmed, you will appear before any duly constituted committee of the Congress if asked?

Mr. CHILTON. I will.

Mr. O'MALIA. I will.

Ms. SOMMERS. I will.

Chairman LINCOLN. Great. Thank you. And I would just say to all of our nominees, if you do have family in the room and you would like to introduce them, please do so. Our families are a big part of all of our lives and it is important.

Mine are off in many different places, but I know my sweet dad is looking down on me right now. He was a rice farmer in Arkansas and a salt of the earth man and he is looking down on me today as I take over the Senate Ag Committee, so I hope you all will take that opportunity.

Commissioner Chilton, we would like to hear your statement and we will go through and have questions after that.

STATEMENT OF BARTHOLOMEW CHILTON, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. CHILTON. It is a pleasure to be the first person to say thank you, Madam Chair, and thank you to the members of the Com-

mittee, particularly the former chairs, who have spent so much time on the futures industry, more than you may have wanted, but we appreciate it.

The industry has changed dramatically over time. Agriculture, while it remains critically important not just to me, but to all the members of the Committee, is really only 7 percent of the futures industry right now, as I say, an important part. Euro dollars are the No. 1 traded contract. On the physical side, crude oil is the No. 1 physically traded contract.

The markets are now—even last year I was here, it was 80 percent traded electronically. Now it is 90 percent, so the pits are sort of on their way out. The futures industry just in this decade has increased fivefold and \$200 billion has come in from what I term as new speculators, and these are different market participants. These are university endowments, hedge funds, pension funds from state and local government, electronically traded funds, index funds, et cetera.

They have a different *modus operandi* from the traditional commercial participants who have been in these markets, like farmers and ranchers and processors. They are different in really two primary ways. First of all, they do not have an interest in the underlying physical commodity, whether or not it is wheat, corn, cotton, soybeans, or crude oil, et cetera.

Second, their trading strategy is different in that they are not concerned about the daily ups and downs or supply and demand. We term them sometimes price insensitive and I am talking generically about them. Everybody has a little bit different strategy. But what that means is they are concerned with a longer time horizon in trading. They are concerned with, for example, if crude oil will be worth more in 5 years than say it is today, but not so much in the daily stuff.

And so there is a question about whether or not these new speculators have had an impact that may have been unintended on markets, creating an artificial price. Rice University recently said that they were. The Petersen Institute earlier this week, or maybe last week, said that they were. But in fairness, there are lots of studies that say that they are not having an impact.

So as a regulator, what do you do? My view is they are having some impact. Two hundred billion dollars, I think, has an effect. Now I am not suggesting they are driving prices or I think the fundamentals of supply and demand are well intact, but they are having an impact.

But even if you just suggest that it is possible that these new speculators here are having an impact, it is uneconomic, and by that I mean divorced from supply and demand. Even if they are artificially having an impact on prices or have the possibility of it, the Commodity Exchange Act says that we are to deter that. So what appropriate mechanisms do we use that you all have given us through the act to try and ensure that there is no fraud, abuse or manipulation? One of the things we are looking at is putting a limit on positions for traders.

This has worked pretty well with some hiccups, significant hiccups in the last couple of years actually, but it has worked fairly well in the Ag complex. But we do not have it in the energy com-

plex. We do not have position limits in the back months and we do not have them in the metals complex either.

So I think some reasonable level may be appropriate. We have never been about saying to a trader, you are not tall enough to ride, you cannot participate in these markets. But it seems to me that if it is impacting the risk that commercial producers are using, that we certainly need to consider it. But we need to look at all of the markets, not just the regulated markets, and that means the over-the-counter markets, which are currently unregulated.

In that regard, there are three things that I would like you all to consider on this Committee and in Congress that I hope will be included as part of what you do on regulatory reform. First of all, I would like to ensure that we get this OTC authority to look at the OTC markets and to regulate it when it is going to impact price, the price that people pay for gas and putting it in their cars or food on their table.

Second, our manipulation authority needs to be, though standard, needs to be lowered. People have a hard time believing this. In the 35 years that the CFTC has almost been around, we have only had one, one successful manipulation prosecution and that one is under appeal. So clearly the standard needs to be lowered.

And the third thing is criminal authority. I would like to get more of these financial felons and financial fraudsters put in jail. If they do the financial crime, they should do the time, something similar to what Beretta used to say. Now they just pay the civil monetary fine. It does not quite have the same zip to it, does it? And it does not have a deterrent effect either.

And the final thing, and this is something I think we can do back at the ranch at the CFTC, not for you all, but I want you to know that we are on the case, and that is dealing with consumers. All of these market participants, there is a lot of new retail participants, a lot of individuals who are trading and they are in their basements and offices, et cetera, and we do not have anybody right now at the CFTC whose mission, mandate and mantra is consumer literacy, helping them understand what is going on and how these markets work.

If you look at what has been going on with all the Ponzi cases, there is rampant Ponzimonian going on, not just in the U.S., but around the world, and we need to do a better job. A lot of folks that have good hearts and limited incomes are being taken advantage from fraudsters and I am hopeful that with the people dedicated to consumer education and consumer affairs at the CFTC that we will do a lot better job in the future.

Thanks. Congratulations again, and I look forward to taking any questions at the appropriate point.

[The prepared statement of Mr. Chilton can be found on page 50 in the appendix.]

Chairman LINCOLN. Thank you, Commissioner. I also would like to—as we are looking to fill the seats here at the CFTC and bring good help over there, Chairman Genzler, where is—there he is right there. He is hiding. I did not see him at first.

Chairman please stand up and let us thank you for the job that you do.

Mr. CHILTON. Commissioner Dunn is also here with us.

[Applause.]

Chairman LINCOLN. And Mike? I saw Mike when he was coming in and waved at him. Mike Dunn as well as commissioner. So thank both of you gentlemen. We appreciate your being here.

[Applause.]

Chairman LINCOLN. Mr. O'Malia.

STATEMENT OF SCOTT O' MALIA, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. O'MALIA. Madam Chairman, Ranking Member Chambliss and members of the Committee, thank you for the opportunity to testify today. Madam Chairman, I would like to congratulate you on your accepting the chairmanship of this Committee. As a father of three daughters, we are always looking for positive role models, and today is a very good teaching lesson.

I am grateful to appear before you as President Obama's nominee to serve as commissioner of the Commodity Futures Trading Commission. I would like to thank Senator Bennett for his support and willingness to introduce me to the Committee. As a Michigan native, I would also like to thank Senator Stabenow for her support as well.

Before I begin, I would take you up on your offer to introduce my family. I am joined by my wife, Marissa, three daughters, Kelsey, Claire and Macey, and I am joined by my parents, John and Bev O'Malia. I appreciate their—

Chairman LINCOLN. Why doesn't everybody stand up so we can greet you as well?

[Applause.]

Mr. O'MALIA. I am honored to be nominated by the president to serve on the CFTC. Given the fact that this country has experienced the worst financial meltdown since the Great Depression, I recognize the enormous responsibility of this office. Like everyone in this nation, I too have lost value in my home, retirement and college savings. I am sensitized to the hardship this crisis has caused families across the country.

This experience reinforces my strong belief that our nation's financial regulators must be vigilant in their oversight responsibilities to ensure transparency and accountability in our markets. Furthermore, regulators must recognize the inherent risk associated with trading products which have contributed to the crisis and they must commit to doing all they can to maintain stability and security of these markets.

I believe the oversight of our financial institutions must be strengthened. I am committed to exposing the underlying risks and trading practices that might further destabilize our economy. For the past 6 years, I have worked in the Senate serving in the Senate Energy and Natural Resources Committee and the Senate Appropriations Committee. During this time, I have focused my work on energy policy with the goal of reducing our nation's dependency on foreign energy resources and expanding U.S. investments in clean energy technologies.

Over the past 3 years, the Senate Energy and Water Subcommittee has authorized and appropriated over \$50 billion worth of self-financed loan guarantees. It has invested tens of billions of

dollars into research and development to support the deployment of clean energy technology. Transformation of our energy sector is more than Federal research assistance. It requires billions of dollars in new investment that will only occur if investors believe that markets are stable, provide reliable price transparency and offer the opportunity to hedge their commercial risks.

Prior to joining the Senate Energy Committee, I spent 2 years in the electricity sector. This experience provided an invaluable education regarding the devastating impacts of flawed market design and illegal trading behavior can have on consumers. As a result of this experience, I am resolved to prevent this catastrophe from being repeated.

I joined Mirant in February 2001 as the director of Federal affairs, focused on Federal energy policy. I did not work for a trading desk or for a business unit that managed generation assets. By the time I arrived, it was already apparent the California electricity market was dysfunctional. California had experienced a difficult summer with record energy prices and a blackout in June of 2000.

By November of 2000, FERC had determined that the California market was flawed and making it possible for manipulative trading behavior to cause an imbalance in supply and demand and made the determination that electricity rates were unjust and unreasonable.

In response to the trading behavior uncovered in 2001, I worked with Mirant's chief risk officer and five other energy companies to establish the Committee of Chief Risk Officers. This organization was created to prevent and avoid the trading abuses used by some in the industry to manipulate California and western energy markets.

The CCRO established industry wide trading protocols, improved price disclosure, encouraged clearing and standardized contracts and established a corporate trading code of conduct. These standards would give regulators, consumers and investors a better view of the business and operations of these companies. I do recognize that many of the same reforms implemented by the chief risk officers are now embodied in the financial overhaul proposed by the administration, but on a larger scale.

Both efforts seek to improve transparency of over-the-counter markets, reduce systemic risk and set trading standards to reduce opportunities for excessive manipulation and speculation. A key component of both efforts has been the utilization of clearing to reduce counterparty risks and allocate capital more efficiently.

My experience reaffirms my strong belief that regulators are critical to ensuring that markets operate in a fair and transparent manner. To achieve this, regulators must be provided with the appropriate authority and tools to respond to the constant evolution, market behavior and products.

As I stated in the beginning, I am sensitive to the impacts the financial crisis has had on all families. I understand the consequences to all of us if the markets are manipulated and expose our financial system to greater peril. Drawing on my extensive energy background, I believe I can make a significant contribution to the Commission.

If confirmed, I will work with the other commissioners to ensure markets continue to offer consumers and producers a cost-effective hedge to their commercial risk. I will work to ensure the CFTC uses all the legal authorities to curb excessive speculation and prevent abusive trading practices, including fraud and manipulation.

I would like to thank the Committee for holding this hearing and considering my nomination. It would be an honor and privilege for me to serve on the Commission. Thank you.

[The prepared statement of Mr. O'Malia can be found on page 56 in the appendix.]

Chairman LINCOLN. Thank you, Mr. O'Malia.

Commissioner Sommers, welcome to the Committee.

STATEMENT OF JILL SOMMERS, NOMINEE TO BE A COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Ms. SOMMERS. Thank you, Madam Chairman, and congratulations to you on this historic day for you. I would like to take this opportunity to introduce my husband, Mike Sommers, who is here with me today. I appreciate his support in being here.

Chairman Lincoln, Ranking Member Chambliss and other distinguished members of the Agriculture Committee, I am honored to be nominated by President Obama for another term as commissioner of the Commodity Futures Trading Commission. I have been in this position since August of 2007 and it has been a true privilege to serve the American public as a regulator of U.S. commodity futures and options markets.

During my career, I have had the opportunity to work on agricultural issues for Senator Bob Dole, for a regulated derivatives exchange, as well as for the trade association representing participants in the privately negotiated derivatives industry. I believe this unique experience gives me a diverse view of risk management issues and the knowledge to help implement our core mission at the CFTC.

The Commission applies a strong regulatory oversight program that includes market surveillance to detect and prevent manipulation, as well as ensuring the financial integrity of the clearing process. This risk tailored approach to regulation is complimented by strong enforcement, as evidenced by over \$2.8 billion worth of penalties and restitution assessed in actions brought by the CFTC since the year 2002.

This regulatory regime has enabled the futures industry to experience enormous growth over the past decade. In 2000, the U.S. exchange traded volume was a little over 500 million contracts. In 2009, the volume has increased 180 percent to almost 3 billion contracts. Even with that growth, the regulated futures industry did not endure the loss of any customer funds during the current economic turmoil due to the failure of a futures commission merchant.

Although the regulated futures exchanges and FCMs have performed well throughout the financial crisis, there is widespread belief that the CFTC's regulatory authority should be extended to cover the trading of over-the-counter derivatives. There is broad consensus that more transparency must be brought to these markets.

The current commission is unified in support of comprehensive regulatory reforms, including full regulation of over-the-counter markets. This regulatory framework would cover both the OTC derivatives dealers and the OTC derivatives markets in which they trade.

I believe that we need to enhance transparency and close gaps to improve the regulatory structure. The CFTC has undertaken a number of initiatives over the past year to strengthen our regulatory oversight and enhance public confidence in the markets we regulate.

Under the leadership of Chairman Gary Gensler, we have held hearings to review the application of and exemptions from position limits. We have convened unprecedented joint meetings with the Securities and Exchange Commission to discuss issues of regulation, harmonization and finally, we have implemented two new transparency measures by further disaggregating our Commitments of Traders report and publishing an updated report, Index Investment Data, based on the information we have been receiving through our special call authority.

It is a very challenging time for the Commission and the questions surrounding all of these issues are enormously complex and require thoughtful resolutions. As a commissioner at the CFTC, I believe there is a historic opportunity to reshape the regulatory oversight of financial markets.

If confirmed by this Committee and the U.S. Senate, I will work hard to ensure that the CFTC continues its role of protecting the integrity of the markets while addressing the concerns about the regulatory structure. It is the responsibility of the Commodity Futures Trading Commission to defend the crucial risk management and price discovery functions for American farmers, ranchers, end users and all market participants around the globe.

Thank you.

[The prepared statement of Ms. Sommers can be found on page 61 in the appendix.]

Chairman LINCOLN. Thank you, Commissioner. We will start our 5-minute round of questioning and I will kick that off and then kick it over to my colleague, Senator Chambliss.

But first of all, Mr. Chilton, you have been an outspoken proponent for changes to our current regulatory system. Do you believe that the Treasury proposal regarding the OTC or the over-the-counter derivatives is sufficient to address these regulatory gaps, and if not, what needs to be done to improve upon the Treasury's white papers?

Mr. CHILTON. Thank you, Madam Chair. Yes, I do believe the Treasury proposal is a good proposal. Right now we can't see a whole segment of the market and it does impact price on the regulated exchange, so we are sort of operating with one eye closed.

My view used to be that I wanted to get the information from OTC and then make a determination as to whether or not it was price discovery and we should regulate it. Now I think it needs regulation. Contrary to some of my colleagues and to some senators, I am not 100 percent sure that we need to look at every individual bilateral trade.

Should I care as a regulator about a relationship between a contract, for example, between a farmer and a co-op? I guess if we had unlimited staff that might be interesting, but I am more concerned with the large trades that can impact price and for me, it is really important that whatever we do, if we do something on position limits, that we keep that in mind.

I am not suggesting that we need to get the regulatory authority to oversee the OTC market before we act on position limits, but we definitely need to be thinking about it in a panoptic fashion to ensure that we are making the right balanced and appropriate calls.

Chairman LINCOLN. If the Treasury proposal were to pass this year, what would be the greatest challenges for the Commission?

Mr. CHILTON. Well we got a big staffing challenge in general and I do want to thank the Congress, particularly those that are appropriators also, for helping us out a lot. The SEC has about 3,500 folks. We have about 500 folks.

The market capitalization, the CME group, is larger than the New York Stock Exchange, so we are doing a lot with a little. You know how things work in Congress; you get the authority then you get the people to do it. So there is always that gap 8 months after you pass something, then we are up here explaining why we have not implemented it yet.

So I think the biggest challenge will be actually getting the bodies on the ground to do the work. But I am confident we can do it. We have a great leader in Chairman Genzler and I am sure we can make steadfast progress.

Chairman LINCOLN. Ms. Sommers, Commissioner Sommers, I want to thank you for the work that you have done on the Commission as well. You might, if there is any of those two questions that you would like to comment on in terms of the Treasury's proposal and what you all need most over at CFTC, and then also you might just touch on the career you have had working with both the Chicago Mercantile and the International Swaps and Derivatives. Any of the roles that you had there both with CME and ISDA, how that experience really informed you or informed how you approached the work you do as a regulator.

Ms. SOMMERS. Thank you, Madam Chair. I agree with Bart and believe that the Treasury proposal includes much needed regulatory reform for our financial markets. Two of the main issues included in the Treasury proposal would give the CFTC jurisdiction over the OTC derivatives dealers and markets, along with other regulators, would bring regulation to those markets. It also includes encouragement for central counterparty clearing, which is very important. It brings market discipline and the daily market to market to those transactions.

So I think both the clearing and that jurisdiction is important for us. My experience from both the regulated exchange environment, as well as the experience I have had with the swaps industry, I think is especially important right now. I do support the Treasury proposal's inclusion of jurisdiction over those OTC markets, and I believe for the CFTC to be able to bring transparency to the public about the markets that we regulate we need the transparency from those markets.

Chairman LINCOLN. Great. Mr. O'Malia, just briefly, you did spend, and you mentioned in your opening statement that you spent part of your career working with Mirant Corporation, of course, at a very difficult time in California, and I know there have been recent news articles describing Mirant as an energy supplier and trading outfit that may have contributed to some of those problems that plagued California; would really like to just hear from you.

I think you have great—I believe that you have valuable experience and great experience to be able to bring to the Commission. Would like to ask you to—maybe you would give us an opportunity to discuss the commitment to the Commission and the mission of the Commission in protecting these markets.

Mr. O'MALIA. Absolutely. The California experience, my time at Mirant, was an important lesson. It was a painful lesson for obviously Western energy markets and consumers of California. Many companies were—went into bankruptcy as a result of the markets and it was clear that manipulative trading behavior was employed to take advantage of those markets.

The rules were not right and that exposed the weakness to it. There was not adequate oversight and there was not adequate regulation. I bring that experience to this position and with my eyes wide open and vow never to allow those type of behaviors to begin or occur in those markets and any of the markets.

I think the discussion about the financial overhaul is consistent with many of the reforms the industry tried to make when it was clear that changes had to be made. There was lack of confidence. There was manipulative behavior and they had to put a stop to that. We need to continue those and strongly enforce those.

There is no room for manipulative behavior in any of our markets and I will ensure that I will be very effective and enforceful of those efforts. The Treasury proposal would expand oversight of OTC markets where there was no oversight and we should encourage the use of clearing houses. As both commissioners, it brings a spotlight on it. It reduces systemic risk and everybody has a clear picture of what is going on in those markets and that is very important to see what is going on in those markets.

Chairman LINCOLN. Great. Thank you. Senator Chambliss.

Senator CHAMBLISS. Thank you, Madam Chairman, and I would first like to ask that three letters in support of Mr. O'Malia's nominations from Senators Murray, Bingaman and Dorgan to you and I be submitted into the record.

Chairman LINCOLN. Without objection.

[The information referred to can be found on pages 213-215 in the appendix.]

Senator CHAMBLISS. Mr. Chilton, I appreciate your comments relative to position limits and as you know, I have had a serious concern about what a change in position limits will do relative to not just our domestic market, but the reaction that we might have overseas.

I understand that Chairman Genzler was in Europe last week discussing the need to harmonize a new structure for over-the-counter derivatives trading, but unfortunately, I have seen little coverage of the European regulators' interest in enforcing more

stringent position limits and I know we will talk more about this later. But in fact to the contrary, I note that Commissioner Dunn recently expressed concern that other regulators abroad may not see the need to tighten position limits.

Meanwhile, just the rumor that CFTC is considering tighter position limits and hedge exemption requirements for our own exchange transactions has already lead a large exchange traded fund to seek larger positions in the over-the-counter arena rather than conduct business on exchange. Certainly that is not the intended outcome.

You have suggested that we ought to apply aggregate position limits across OTC in exchange traded positions. But the proof now exists that large market participants faced with limitations will seek creative alternatives and I am concerned it might force them off to exchanges in Europe or elsewhere.

I mean, we may even see other countries develop mechanisms for trading over the counter. How do you propose that the U.S. responsibly apply position limits so as to avoid a migration of markets abroad?

Mr. CHILTON. Well let me say I agree with you 100 percent, Senator, that we need to be very careful how we do this. That is why I say that whatever we do, we need to do it in light of the OTC legislation or the regulatory reform legislation that I hope Congress will consider. It could have the effect, if we are overzealous regulators of moving it to less transparent markets or moving it overseas, that would be a perverse impact to what I think some of us think we need to do.

We have reached the right balance on the ags. As I say, by and large, they have worked pretty well. I know there are some issues that both of us share with regard to some of the specific Ag commodity markets, but by and large, these position limits have worked well for the ags and I think as long as we go into this in a balanced and reasoned way, we can do it so it will not move business off.

That is certainly not something I am interested in. With regard to the Europeans, I think you are right, they perhaps have not been as strong, but I can tell you one thing, Gary Genzler is not a shrinking violet and I know that he has had some pretty explicit conversations with them. I look forward to seeing something public from the Europeans.

But I think in general, as regulators, we sort of need to move in this direction. But we need to be careful, you are absolutely right, about how we go forward.

Senator CHAMBLISS. Both Chairman Genzler and Secretary Geithner and I have had conversations about the fact that we need to bring the Europeans on board. There needs to be some sort of international standard here and whatever we do with respect to the proposed changes in the legislation, obviously, we need to keep that in mind. You guys do not toot your horn enough, but I think it is an absolutely correct statement to say that because of the work in part that you all have done at the Commission from an oversight standpoint, as well as what is going on at the SEC, even though we have had some mistakes that have been made, the markets that you folks regulate did not fail. The markets worked and

Lord knows what would have happened in these tough economic times a year ago if we had seen the markets fail.

But you all did a good job in providing the necessary oversight to ensure that there was no failure and you need to be commended for that.

Mr. O'Malia, over the course of the past few months, we witnessed a breakdown in the financial system and we have heard a great deal about systemic risks. While there are certainly a number of factors that contributed to this situation, many have blamed the lack of regulation applied to the over-the-counter derivatives and some have suggested that regulators of securities and futures need to be authorized to do more.

Obviously we are now tasked with determining what additional authorities are necessary? Rather than tasking various regulatory agencies with duplicative functions and confusing market participants, we should seek to ensure an efficient coordination among regulators. If confirmed, how do you intend to work with other regulators, such as the SEC, to harmonize your respective functions?

Mr. O'MALIA. Both the SEC and the FERC are two agencies that deal with products before the CFTC. I am committed, obviously, to work with those agencies to harmonize the regs to the extent we can. The Treasury proposal did have a joint regulation on mixed swaps.

I think Chairman Genzler did get it right and said we ought to divide those along the lines of expertise and I would support his position on that to ensure that we do not have two regulators trying to solve one problem. Tasking those along the lines of experience makes sense to me.

Senator CHAMBLISS. Chairman Sommers, you currently chair the CFTC's Global Markets Advisory Committee and you have witnessed technological advances leading to a more global marketplace. Some have criticized this evolution in which foreign boards of trade now have greater access to U.S. traders and our U.S. exchanges have greater access to traders abroad.

Could you briefly explain how the CFTC and various foreign regulators coordinate in order to ensure appropriate oversight of the markets across oceans and the borders? I was a little more specific with Commissioner Chilton regarding position limits and how we are going to deal in this arena with our overseas traders and you can expand on that, if you will, please.

Ms. SOMMERS. Thank you, Senator. As you know, foreign boards of trade that wish to offer their products to either U.S. members of their exchange or other U.S. customers must come to the CFTC to get relief in order to offer those products to U.S. customers.

We, in considering this relief for foreign boards of trade, we look at the home country regulator and we look to see if the regulation applied to that foreign board of trade is comparable to what we apply in the United States. We also look to memorandums of understanding that we have signed with their home country regulator. The CFTC is a member of the International Organization of Securities Commissions and we sign a worldwide multi-lateral memorandum of understanding that creates standards and we use that MMOU as a basis for approving those foreign boards of trade as well.

And I think as we look forward on the issue of considering either imposing position limits on our specifically energy and metals complex or the exemptions from those position limits, that it is an issue of concern that we continue to work with our global counterparties to make sure that those are also issues that they are considering, because I do share your concern. If we impose those limits without having our global counterparties in lock step with us, we may have the perverse effect of driving business to other markets globally and making our U.S. regulated exchanges less competitive.

Senator CHAMBLISS. My time is up, but there is one other critical follow-up question I would like to ask you. I know we have a current relationship with the London Exchange on the trading, particularly for oil contracts, where they voluntarily provide us with certain information.

Let me address this to you and Commissioner Chilton. Are you folks satisfied with the information that you are getting from the London Exchange on these contracts?

Ms. SOMMERS. I think, Senator, that that is a perfect example of how well our foreign board of trade regime has worked. This year, we have made significant modifications to our memorandum of understanding with the UK FSA in order to address that linked contract that is listed on a foreign board of trade that is priced off a U.S. contract or settles to that U.S. contract.

We have made modifications to that memorandum information sharing, as well as with the enforcement authorities, so we do get large trader data on a daily basis from that exchange, as well as have other information sharing agreements and enforcement availability with that agreement.

Mr. CHILTON. Yeah, I would echo what Commissioner Sommers said. I am satisfied. We get it on a daily basis. It is in real time. It is in the same format. We actually print it in our Commitment of Traders report, so it is very helpful.

It would not bother me if it is codified. Now it is this thing we call a no-action process and it is a little convoluted. As Commissioner Sommers said, we have worked it out and I think everything is fine now. But I would not mind having—if we are doing—if you all are doing regulatory reform, having it codified by a statute. But it is working well now, Senator.

Senator CHAMBLISS. Thank you.

Chairman LINCOLN. Senator Lugar.

Senator LUGAR. Thank you, Madam Chairman. Commissioner Chilton, I think you were present perhaps about a year ago when we had a hearing of this Committee. On that occasion, we had a witness that tried to describe to the Committee what was occurring in the financial crisis.²¹ Anecdotal, you went through the situation where the local banker was out there trying to get a lot of the mortgages on the books. Having collected all these, these were packaged. It was sent on to another bank, sometimes sold, and folks were out of it altogether locally, packaged again and moved on somewhere else.

Now finally, at a level of some bank or institution, it had a lot of these packages. It was explained you go to a place like AIG to get insurance and you get insurance through derivatives, let's say. So then we, as amateurs, sort of press, what kind of derivatives are

these? Well some look fairly straightforward. This is an insurance derivative. But then one witness add, but you could also express opinions.

And so he said, is this like an opinion poll in addition to an insurance policy? He said, well not exactly, but for example, you might bet on the fact that the banking system of Pakistan was going to fail and as a result, even though it has nothing to do necessarily with what the flow had been thus far, if it failed. You might get a payoff, or as some of the other insurance situations, it might not work out, including maybe AIG being able to pay you.

This came as a surprise to many members as to what kind of statement or ink on paper, and so we got into this situation that these derivative functions are not all ones in which you know the parties, the party or the counterparty, or as a matter of fact, we then had, some of us, visits from bankers who said, now as you begin to think about regulation, do not pin this down. We need to have a lot of creative space to write these situations. They are not all the same.

We are talking about clearing not identical contracts, very different. This is not very reassuring to those of us who are citizen amateurs of this quite apart, I think, from the financial community, and we are still, as you pointed out, although CFTC always was thought of by many as having agriculture commodities, the financial instruments became very large in your situation quite apart from the energy situation, which in the last reauthorization of CFTC somehow got omitted or had not the same weight.

This is all the beginning of a question. What in the current CFTC proposals or laws that Treasury is offering, or anybody is offering, finally brings us into some clearing function of counterparties where we actually have, even complex as it is, something that is relatively uniform as opposed to totally creative in ways that—once again creative bankers, financial people and so forth, in a search, in our American free enterprise system for wealth, blow the whole thing out; can you give us some reassurance?

Mr. CHILTON. I can give you some, Senator, although I am not going to vouch for that entire situation you described, because I had some of the very same concerns. It was the Commodity Futures Modernization Act, which codified that we would not be regulating swaps and these credit default swaps that you are talking about really metastasized throughout the banking and the trading community. It would have been difficult to follow even if you re regulating them, but certainly unregulated they lead to many of the problems that you describe, in particular AIG.

It is all hindsight now, but I venture to say that if credit default swaps were regulated, that may not have happened. And so I think it is one of the things that you described, Senator Lugar, that was probably a mistake in CFMA. In my view, there are many good things in CFMA. It has allowed the free market to flourish, to be innovative and look around the corner and be competitive. But that is one of the things that I think was an inadvertent policy.

The administration has called for regulation of these types of swaps. It has sort of left the door open.

to who would regulate them, whether or not it would be the CFTC or the SEC. In my view, as a CFTC regulator, it would be

easy to just say well we should have it. But to be honest with you, I just care that it is regulated. I just want to make sure that somebody is looking at this.

We can do it. Again, we need staff to do it. And we can do a competent job, but I think for American consumers, it is just important that somebody who comes before you all, or another committee who is responsible for this type of thing, looks at it very hard and carefully and always has in the back of their mind, how are we protecting consumers? How are we protecting markets?

Senator LUGAR. Well this begs then my second question and that is, perhaps you do not have control of this now or oversight. Maybe you will. You certainly do have all of the energy situations and the Ag is a very small part, as you have said.

Now last year at this same time, the complaint was made that the staff problems at CFTC, even with what you had, were totally inadequate in terms of number of people. There were senators piling on about speculation and all the difficulties and you and the chairman, what have you, were saying well, give us some people.

Now you intimate you do not have the people yet. I am trying to sort of fathom where in the system you get the people. Have you requested them? Are they in somebody's appropriation authorization bill or anyone in the stream at this point?

Mr. CHILTON. Yes, sir. We have—I cannot give you the specific numbers, but I said we were at 500 in my oral remarks. I think we are going to actually be closer to 600 like today, maybe 599, and we have a request in for more. I cannot give you the exact amount, but we are moving forward. We are now at the Financial Services Ag—or the Financial Services Appropriations Subcommittee.

But with the support over the years, we have done a lot better. But as I say, we have a big workload out there and depending upon what happens with some other issues, for example, carbon trading, if that ends up passing and we have that, that could be the largest commodity market, physical commodity market in the world.

And so I appreciate the question and appreciate the support, Senator, and we are going to continue to need it as we go through the appropriation cycle. But we have requested it so far and I think we are moving in the right direction.

Senator LUGAR. Thank you. Thank you.

Chairman LINCOLN. Senator Cochran.

Senator COCHRAN. It occurs to me, Mr. Chilton, listening to your testimony and expression of concerns about the inadequacy of the power or authority of the CFTC, that you are making an argument for additional definitive powers and responsibilities that would be defined by Congress and enacted so that you could do the things that you are saying ought to be done.

Is there an issue now between this agency and other agencies or departments of the government where they are also seeking that kind of definitive acknowledgement of power and responsibility? What is the state of play in the definition of legal authority?

Mr. CHILTON. Well with regard to what Senator Lugar was asking with regard to clearing and swaps, particularly credit default swaps that were \$55 to \$60 trillion, I mean just a monstrous number, the SEC is also interested in that and really I think the ad-

ministration deserves to be commended by coming out with such a strong proposal and doing it fairly on.

But in all candor, they punted on the question of whether or not it was going to be the jurisdiction of this Committee or the Banking Committee and again, it would be easy to say turfs, that we should do it here, but as long as it is done. And so I will leave those important decisions to you and other senators.

Senator COCHRAN. That is reassuring, and that you are not about to go out and start regulating and start bringing in people and start finding violations of the law as a commission, as an administrative body, without the color of that authority.

Mr. CHILTON. Yes.

Senator COCHRAN. You do not have that in your background as an inevitable conflict that you are going to have if you are—

Mr. CHILTON. No, I do not, Senator. I mean, I think there are some things we can do through the rulemaking authority with regard to position limits and hedge exemptions, but again, we need to do that with a view toward the unregulated markets and we need to do it, as I was discussing with Senator Chambliss, in a way that does not send markets—it does not send current regulated traders to unregulated markets or does not send them overseas.

So we need to be very careful about this, but my colleagues are smart folks. We are going to get this right. We are going to do the same types of things that you all do every day and make sure that we are not losing markets and make sure that we are protecting consumers.

Senator COCHRAN. Well, do not use us as a role model.

Mr. CHILTON. I know you too well, Senator. You have done a lot of good work over the—

Senator COCHRAN. Individual senators are different from the body as a whole.

[Laughter.]

Senator COCHRAN. Thank you very much for agreeing to serve in these positions. This is going to be a very challenging period, I think. I think the Committee will do well to follow very closely how all this plays out. Thank you.

Chairman LINCOLN. Be assured, Senator Cochran, we will be, as a Committee, following very closely in terms of what the responsibilities—and you are right, it is a tall order at this juncture in our economy and in the world economy, so we will definitely be following closely.

Senator Thune.

Senator THUNE. Thank you, Madam Chair, and congratulations to you on your historic accomplishment, first woman and first Arkansan as the chairman of this great Committee. Your style and approach to dealing with issues will serve this Committee and its members and the entire Senate very well, so congratulations and just do not forget about us northerners up there. We will bring you up to South Dakota to give you a chance to visit somewhere soon.

Senator COCHRAN. We learned our lesson.

[Laughter.]

Senator THUNE. All right. On a more serious note—

[Laughter.]

Senator THUNE. Let me, if I might, just pose a question to whom-ever, maybe to Commissioner Chilton to start with. But if the Congress were to require mandatory reporting for all OTC transactions, what additional resources would the CFTC need to manage such a large amount of data? And maybe Commissioner Sommers could answer.

Mr. CHILTON. I do not have an exact number, Senator Thune, but it seems to me that, as I said, 3,500 or thereabouts with the SEC, 500, 600 at the CFTC. I would like to see us up in the 700 full-time equivalent positions in the not too distant future, and that is without anything with regard to carbon.

So we could use another 100 people sort of pdq and I think we need to continue to request more and ramp up. You know, there is a limit to how large we should get certainly. We do not want to be overly bureaucratic, but right now, as Senator Lugar described, we have a lot of challenges that we just are not up to, and it is not because we do not have dedicated and resourceful and professional staff; we do.

Senator THUNE. Anything to add?

Ms. SOMMERS. Senator Thune, I think we have to continue to consider that the OTC markets are large and they are very complex and they are markets that the CFTC does not have experience in regulating. So it is something that will be an enormous task for us.

But as Commissioner Chilton noted, we have hired, I think, almost 100 people over the last year and if things progress the way that we hope with the budget this year, we will be able to do the same next year, and that will be very helpful for us, not only with actual bodies on the job, but with advances in technology to help us survey all those markets as well.

Mr. O'MALIA. Senator, if I may, the people are important. Working in the appropriations, we have had the opportunity to work with our national labs and see what technology can do for us, specifically world class computing. It seems to me we also—there is a technology element that we have to stay ahead of the markets, or at least keep up with them. The investment in that category has been woefully inadequate.

We really need to focus on taking advantage of the high speed global nature of these markets and avail ourselves to the technology. If confirmed, I would be happy to take that effort on to find out what opportunities we can do to keep up. Keeping up would be a good start.

Senator THUNE. One of the—if climate change legislation were to pass, it would allow third parties like banks and foreign nations to participate in the carbon market. In other words, you would have third parties that are not directly associated with carbon. Offsets would be able to purchase these credits on an exchange.

In your opinion, does that leave the carbon market open to undue influence or manipulation and is it possible under a scenario like that that a third party investor or group of third parties would be able to drive up the price of carbon by purchasing large amounts of allowances or available carbon credits?

Mr. CHILTON. It is a concern that has been raised particularly recently in the last several months that I have heard. You know, we

have, like I say, professional staffs. I think we can do the regulation of this, as long as we have the authority.

Some have argued that the smaller the markets, the easier it is to regulate and while that is true, I would rather have deep liquid markets with lots of trading and you go back and forth between people at the agency center. Some will say it is just another contract. It is just like crude oil.

It has its distinct difference in that the government would, under the legislation proposed, actually control the allocation. And so that is different. But by and large, I am not worried about the size of it as long as we have the resources to police it. I think we can do a good job. And as I say, I think it can have an enormous benefit not just for whatever it can do for the environment, but I think it can add to the economic engine of our democracy, and that is not a bad thing.

Senator THUNE. What role would you see speculators playing in a carbon market and how would you define a speculator? How would you define excessive speculation?

Mr. CHILTON. Right.

Senator THUNE. I mean how would you go about—

Mr. CHILTON. I like speculators. Too often I think speculators get branded as sort of a dirty word. We are going to need people involved in these markets to ensure that they work and I think if you only have commercial participants, the markets will not function as efficiently or as effectively as a lot of us would like.

But we will need to be careful to ensure that there may be—it may be appropriate for example, to put certain limits. Just like we were discussing position limits in the energy and metals complex, I think that is probably appropriate for carbon, to avoid the very things you are asking about.

Senator THUNE. Mr. O'Malia, you are the new guy. What do you think about derivative products being forced onto regulated exchange?

Mr. O'MALIA. We do—the administration has put out a very comprehensive proposal and I believe the transparency and reporting requirements to move more of these products into regulated markets is an important move. Increase, avail ourselves to clearing would be critical, but we do not want to shift everything—standardize everything for the sake of standardization.

We need to make sure that these actually pose a risk of manipulation or threat and that they could impact the overall pricing of commodities. And I agree with those principles. More trading on regulated markets would be helpful. We will be able to see it. We will have clear—it will be priced to the market. They will understand it better and it will be more useful.

Clearing reduces risk and that is helpful. We do not want to make this too costly, however, to make sure the people—everybody who has commercial risk cannot use these. They have to be available.

Senator THUNE. Commissioner Chilton, Commissioner Sommers, what reaction have any of you received from market participants about the administration's proposal to impose capital requirements on dealers of OTC derivatives?

Ms. SOMMERS. Senator, I think that the capital requirements provisions that is in the Treasury proposal is consistent with the capital requirements that we look at in the futures markets. We are also moving forward in the futures markets to impose additional capital requirements on the FCMs in our markets to make sure that is part of our job, to make sure that that risk surveillance and part of what an FCM has in the clearing process is adequate and it is something that we are very mindful of. I have not heard any of the dealers or market users express any concerns about this.

Mr. CHILTON. I agree with Commissioner Sommers and only echo what some of the other senators said and that is that these markets really were not at the heart of the credit crisis and the recession, and you all should take great pride in that.

I mean, we have worked pretty well. This is just a good time for us to think about other sideboards that we may need to put on the law and rules and regulations where appropriate to make sure we continue down that path.

Senator THUNE. Madam Chairman, thank you and I would like to be able to be here for our next panel. I want to hear Mr. Avalos tell us how he is going to get the Ag community united on animal I. d., but I probably will not be able to be around for that.

So thank you all for your willingness to serve, of all of our nominees today, and thank you, Madam Chair.

Chairman LINCOLN. Thank you, Senator Thune. Do any of you all have additional questions for this panel?

Well before I dismiss them, I would like to—one last item for the nominees. As you know, Senator Cantwell has played a leadership role in the Senate with regard to commodities futures regulation and has some questions that I will be submitting for the record.

I know all of us look forward to your responses there and you will have ample time to be able to respond to that and to Senator Cantwell's questions. So thank you again. I echo the words of my colleagues. Thank you for offering yourself in terms of public service. We have a lot of challenges ahead of us.

We are going to be looking to the CFTC for great guidance and opportunities to really grow our economy, but do so in a way that minimizes risk and certainly ensure confidence in the American public. So we appreciate your being here today and we appreciate your willingness to serve.

We will excuse this panel and we may ask the—invite the second panel to come before us.

Senator CHAMBLISS. Madam Chairman, while this panel is coming up, let me just recognize one of my staff that you know well whose probably last hearing is going to be today. Vernie Hubert has been a member of my staff the whole time I have been here in the U.S. Senate and I first got to know Vernie when he worked for a Democratic congressman—

Chairman LINCOLN. I did too.

Senator CHAMBLISS.—Charlie Stenholm, who was such a great advocate of agriculture. I had the pleasure of working with Vernie on both the 1996 Farm Bill and the 2002 Farm Bill and then obviously this past year over here. Vernie has just been such a great asset to the Committee for so many reasons and a particular asset to my staff because of his knowledge of agriculture, his commit-

ment to ensuring that we do the right thing for farmers and ranchers.

He is a guy that we are truly going to miss here. I did not want to let today go by. We have encouraged him and drug him back over here. I would not let him go home last year as soon as the Farm Bill was completed and he has graciously agreed to stay on here this past year. I just want to recognize Vernie as a true asset both to me and to the Committee and particularly publicly to thank him for his service.

Chairman LINCOLN. Well, Senator Chambliss, I would like to join you in that and I too first met Vernie when I was in the House. I would say that his leaving at this juncture is subject to the discretion of the chair.

[Laughter.]

Chairman LINCOLN. So I do not know, but if I am going to exert any powers, this might be the place to do it.

Mr. HUBERT. Can I have you talk to my chairman?

[Laughter.]

Chairman LINCOLN. Well we do appreciate the incredible work that Vernie has put forward on behalf of American agriculture and he has done a tremendous job. All I can say is, please do not go. But we are grateful to him, and grateful to him and grateful to you, Senator Chambliss, for having him on board. He was an enormous part of the negotiations that we had on the Farm Bill and was a real calming effort there and did a tremendous job of pulling people together and we appreciate it.

So I am still going to reserve my right as chairman to have a say in that, but anyway, I know your chairman and I know she will trump me, so nonetheless.

If I can ask this panel to please stand. I am not sure if we all got the swearing in, but I am not going to mess it up on my first watch, that is for sure. If you will raise your right hand.

Do you swear to tell the truth, the whole truth and nothing hut the truth?

Mr. AVALOS. I do.

Mr. SHERMAN. I do.

Mr. SPEARMAN. I do.

Chairman LINCOLN. Great. Our mandatory question, do you agree also that if confirmed you will appear before any duly constituted committee of the Congress if asked?

Mr. AVALOS. Yes.

Mr. SHERMAN. Yes.

Mr. SPEARMAN. Yes.

Chairman LINCOLN. Great. Thank you. Thank you, gentlemen, for joining us today. We appreciate it and appreciate your willingness to also serve. We would like to begin by your statements, if we may, and then we will enter into our questioning.

Mr. Avalos.

STATEMENT OF EDWARD M. AVALOS, NOMINEE TO BE UNDER SECRETARY OF AGRICULTURE FOR MARKETING AND REGULATORY PROGRAMS AND MEMBER OF THE BOARD OF DIRECTORS, COMMODITY CREDIT CORPORATION

Mr. AVALOS. Chairwoman Lincoln and ranking member.

Chambliss, members of the Senate Committee on Agriculture, Nutrition & Forestry, thank you for the opportunity to appear before you today.

Chairwoman Lincoln, I also would like to congratulate you on your new assignment to chair this Committee. I know that the folks back in Arkansas are really proud of you.

Chairman LINCOLN. Thank you.

Mr. AVALOS. And also, this being your first hearing for this Committee where you are in the leadership, I am honored to be a part of this historic event. I am extremely grateful to President Obama for nominating me and Secretary Vilsack for his support.

If I can, Madam Chair, I would like to introduce members of my family.

Chairman LINCOLN. Please do.

Mr. AVALOS. I think I am going to read it, and then they can just—anyway, I have my better half, Anna Bee, from Mesilla, New Mexico; my daughter Alexandra and her fiance, Tom. They are from Long Beach, California. My daughter Megan and her fiance, Mark, from Phoenix, Arizona; and of course, my son, he is my fishing and hunting buddy, Russell, from Las Cruces, Mexico. I also have quite a few friends that came all the way from Las Cruces, well actually from all over New Mexico, to be here with us.

Chairman LINCOLN. That is wonderful. Please stand so we can welcome you to the Committee.

[Applause.]

Chairman LINCOLN. That is quite a cheering squad.

Mr. AVALOS. I almost have a basketball team.

Chairman LINCOLN. That is right.

Mr. AVALOS. Madam Chair, members of the Committee, it really is an honor to be nominated to serve as the under secretary for marketing and regulatory programs at the U.S. Department of Agriculture. The mission includes the Agricultural Marketing Service, the Animal and Plant Health Inspection Service and the Grain Inspection Packers and Stockyards Administration.

Each of these agencies are extremely important and contributes to benefit the agricultural industry all the way from the producer through the shipper, the processor, the retailer and on to the consumer.

I grew up on a family farm in the Mesilla Valley in Southern New Mexico. At an early age, my parents, Adolfo and Eva Avalos, they instilled a very strong work ethic which I have followed through my entire career. My 30-plus years of experience in agricultural marketing have prepared me for my role as the under secretary. I have worked with the agricultural industry to address regulatory, marketing, production and other issues and challenges in both the national and international arenas.

I am a firm believer that the U.S. agricultural sector has been and continues to be the backbone of this country, providing food and fiber to consumers and end users in the U.S. and also in markets all over the world. During my career, I gained considerable experience in both the international and domestic arena. I have worked to support the production and marketing of livestock, specialty crops, value added products to the implementation of trade missions, dialog and promotion.

Also I have worked with diverse stakeholders to develop and establish and maintain markets for sheep, cattle, goats and numerous fruits and vegetables in Mexico, onions and processed foods to Canada, and most recently, the pecan growers' success in creating an export market in China.

In the domestic arena, I have been very successful in establishing markets for chili peppers, onions, potatoes, watermelons, pumpkins, pecans, beans and alfalfa. I have worked closely with producers to support the production of crops that the industry demands. I worked with the distributors for timely delivery of goods and with retailers to showcase, promote, sell, educate and inform the consumer utilizing brochures, recipes and other promotional and educational tools.

In addition, I have worked to advance Indian agriculture, including working closely with the Navajo Agricultural Products Industry. This is an 85,000-acre farming enterprise located on the Navajo Nation in the four corners area of New Mexico and with some of the Indian pueblos in Northern New Mexico to bring back traditional agriculture to their tribes.

I believe it is important to create an atmosphere of collaboration and foster good communication through agriculture production. I am enthusiastic about opportunities to promote fresh and local availability of products, more farmers markets, trade organizations and better connecting the American public with their food supply.

As a result, I have established an effective and informative network of growers, shippers, trade organizations and other stakeholders throughout the country. I have worked closely with the North American Agricultural Marketing officials, the National Association of State Departments of Agriculture and the Western United States Agricultural Trade Association. This network provides me with needed input on issues and trends within the food, agricultural and livestock industries.

If confirmed as the under secretary for marketing and regulatory programs, I will emphasize providing oversight of the three agencies and addressing the concerns of agricultural boards and commissions. If confirmed, I look forward with enthusiasm to stimulating employee morale and working with the many fine public servants which are assigned to my area, as well as the other agencies within USDA.

I am strongly committed to civil rights at the department and will work hard to ensure USDA's employment practices will not tolerate any form of discrimination, but instead will create a positive environment that celebrates and draws upon the strength of USDA's diverse workforce and consumer base.

If confirmed, I am committed and dedicated to working with Secretary Vilsack and this Committee to address and resolve the many concerns and difficult issues that are facing the food, agriculture and livestock sectors of this country. Building on my experience with the farmers, with the ranchers, dairymen, with the shippers and brokers, the food processors, the distributors, retailers and consumers, I will provide the leadership and guidance needed to implement the Farm Bill and carry out the mission of USDA.

Thank you for your consideration and I am happy to respond to any questions.

[The prepared statement of Mr. Avalos can be found on page 48 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Avalos.
Mr. Sherman.

STATEMENT OF HARRIS D. SHERMAN, NOMINEE TO BE UNDER SECRETARY OF AGRICULTURE FOR NATURAL RESOURCES AND ENVIRONMENT AND MEMBER OF THE BOARD OF DIRECTORS, COMMODITY CREDIT CORPORATION

Mr. SHERMAN. Thank you, Madam Chairman. It is a great honor to be here before this Committee today considering my nomination for the position of under secretary for Natural Resources and the Environment. Let me add, Madam Chairman, to the chorus of congratulations to you. I very much look forward to working with you and all of the members of the Committee.

I want to thank my senator, Senator Bennet, for his very kind words of introduction. He is doing a wonderful job with our national forests and our conservation programs, so I appreciate his kind words. And although I brought a somewhat smaller cheering section for me, I wonder if I could introduce my family.

My daughter, Jessa Sherman, from Los Angeles; my brother, David Sherman, from Denver; my sister Barbara Kailey, from Denver; and my niece, Shawn Kailey Reagan, from Los Angeles. If you could all stand up.

[Applause.]

Mr. SHERMAN. Several weeks ago when I received the news that President Obama had nominated me, I was deeply humbled by the honor, but also by the degree of responsibility that accompanies the position. I fully realize that the challenges ahead will not be easy, but it is an extraordinary opportunity to do good for our country.

If confirmed, I promise to use my strengths, energy, commitment and good judgment to advance the conservation and public land programs that will fall under my jurisdiction and I promise to work closely with you and the other committees of Congress as we go forward.

My interest in overseeing the Forest Service and NRCS stems from a lifetime of experiences with public lands and conservation programs. As a child, my parents took me to the mountains outside of Denver where we would camp, hike, fish, ski and jeep. These experiences left an indelible impression on me of the grandeur and the importance of our national forests.

Later I have twice had the privilege of serving under two Colorado Governors, Governor Richard Lamm and Governor Bill Ritter, as the director of the Colorado Department of Natural Resources and I have had the opportunity of working on a daily basis with the Forest Service and other Federal land management agencies on very interesting, complex resource issues. Between these two stints as DNR director, I have represented as an attorney both public and private sector clients in their dealings with Federal land management agencies.

These experiences, combined with earlier work I did with the State Soil Conservation Service, and my later work with many land trust conservation organizations, have given me a background that I believe will serve me well in this new job. Looking forward, there

are tremendous challenges regarding our forests, both Federal and private, and the conservation programs associated with farms and ranches throughout the country.

On the forestry side, many forests are in trouble due to past fire suppression, increase in fuel loads and changes to our climate. As a result, many forests are far more vulnerable to catastrophic fire, disease and invasive species, often in epidemic proportions, such as the situation that we face in Colorado where we have several million acres of dead trees due to Pine Beetle kill.

We are witnessing far more frequent, intense fires. Combining these factors with a growing human population influx within or adjacent to our public and private forests, it is clear that we have a very challenging situation ahead. How we protect our growing communities from fire danger, how we protect the watersheds within our forests that supply drinking water to much of our population, how we protect wildlife species that rely centrally on these forests, and how we ensure that our forests play a critical role as carbon sinks is a herculean responsibility.

I believe that Secretary Vilsack's emphasis on restoration of our forests, both Federal and non-Federal, in a manner that addresses climate change, environmental protection, identifies new markets for wood products, creates jobs and sustains rural communities, provides an excellent framework for moving forward.

It is also important that we take a holistic approach to land conservation. On the NRCS side of the ledger, I have much to learn, but I am very excited by the mission and the scope of the agency's charge. Conservation of private working lands plays a significant role in protecting water resources and wildlife habitat, creating jobs and providing economic opportunities for rural America.

NRCS's watershed protection program helps communities from floods like those that we have just seen in Georgia. With these comprehensive programs, on the ground expertise and powerful technical tools, NRCS is well positioned to help private landowners play a significant role in addressing a variety of the nation's conservation challenges.

So in closing, let me just say, together the Forest Service and NRCS can make a major difference. Never before have agriculture and forestry been more at the forefront of current national policy issues. This is an urgent time to make progress. I am excited by the prospect of devoting my energies to these tasks.

I promise you that if confirmed, I will undertake collaborative efforts involving appropriate stakeholders to find common sense solutions and to come up with answers that will withstand the test of time, becoming durable, long standing and reliable programs. Thank you, Madam Chairman.

[The prepared statement of Mr. Sherman can be found on page 59 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Sherman.
Mr. Spearman.

**STATEMENT OF KENNETH ALBERT SPEARMAN, NOMINEE TO
BE MEMBER OF THE FARM CREDIT ADMINISTRATION
BOARD, FARM CREDIT ADMINISTRATION**

Mr. SPEARMAN. Thank you, Madam Chairman Lincoln and Ranking Member Chambliss and the distinguished members of the Committee. Senator Lincoln, congratulations on assuming the chairmanship of the Committee. I look forward to your leadership and working with you and Senator Chambliss and this Committee for the betterment of American agriculture.

I also want to thank Senator Nelson for his kind and generous introduction. He serves my home state of Florida in the U.S. Senate with honor and distinction. If confirmed, I will keep the trust of his example of public service to our country.

It is a privilege to appear before you today as President Obama's choice to serve as a board member of the Farm Credit Administration. This is a special honor for me and I am honored that my family also is here to share it with me. We all achieve success in life with the help of others. I am no exception, so I especially want to acknowledge my wife, Maria, my twin daughters, Michelle Springs of Orlando, and her sister, Rochelle Puccia, of Los Angeles, and my son, Dr. Kenneth Spearman, of Long Branch, New Jersey.

Chairman LINCOLN. Please stand so we can greet you.
[Applause.]

Mr. SPEARMAN. It is indeed an honor to be nominated to this prestigious position. I would like to share my background and tell you about the skills and experience I would bring to the Farm Credit Administration Board should the Committee confirm my nomination.

As an accountant, I was involved with the development of a public accounting firm in Chicago, Illinois and later worked as an accountant for a major accounting firm. From 1980 to 1991, I served as controller of the Citrus Central, Inc., where I was responsible for the financial management and reporting for this \$100 million agricultural cooperative.

Until recently, I was director of internal audit for Florida's Natural Growers, Inc. There I was responsible for the design and implementation of the annual plan, which was used to appraise the soundness and adequacy and application of accounting, financial and internal operational controls.

I currently serve as an independently appointed outside director on the board of AgFirst Farm Credit Bank, a position I have held since January 2006. As you can see, my professional history, most of my career has been spent working for agricultural cooperatives. During my 28 years in the citrus industry, I gained a deep appreciation for agricultural producers and production agriculture.

As the members of the Committee are well aware, production agriculture, particularly Florida's citrus industry, is capital intensive and heavily reliant on access to a competitive credit. Add in the variables of the marketplace, world events, weather and many other unforeseen factors, and one can see that agriculture is a risky business.

Americans, and for that matter, people around the world should be thankful for the men and women who produce the food and fiber that we enjoy daily and without which we could not survive. As I

said, production agriculture is very capital intensive. Land costs, labor, equipment and fertilizer require long-term and short-term financing. It takes a variety of lenders to meet the credit needs of agricultural producers and their cooperatives.

The Farm Credit System, which is regulated by the Farm Credit Administration, is a very important part of that coalition of lenders required to finance American agriculture. Serving as an outside director of the AgFirst Farm Credit Bank board has given me a new and greater appreciation for the complexity and importance of agricultural and rural finance.

I believe my 28 years of financial experience working for agricultural cooperatives will serve me well as a member of the board of the Farm Credit Administration. I would utilize that expertise to ensure the safety and soundness of the Farm Credit System so that it continues to serve the credit needs of America's farmers, ranchers and their cooperatives.

In closing, I would like to thank the Committee for the important role it plays in the oversight and authorization of the Farm Credit System and its mission to meet the credit and related services needs of America's farmers and rancher.

That concludes my statement and I will welcome any of your questions. Thank you.

[The prepared statement of Mr. Spearman can be found on page 63 in the appendix.]

Chairman LINCOLN. Thank you, Mr. Spearman. I also note that we have another of the FCA board members here with us today, Nancy Pellett. Hey Nancy, welcome to the Committee. We look forward to working with you.

Just a few questions for this panel, if I may. Mr. Sherman, this administration is committed to reducing our dependence on imported oil and natural gas, coal-fired power plants in this country for our energy. Biomass can be converted into energy and fuel, reducing our dependence on fossil fuels and certainly our carbon footprint.

What role do you see USDA and the Forest Service playing in this new initiative, and as under secretary, how will you expedite the decisionmaking and the other processes necessary to get the expected results in a timely manner?

Mr. SHERMAN. Senator, I think both the Forest Service and NRCS have a very important role in exploring the possibilities of biomass to deal with the country's energy security. Obviously our forest products are potentially a form of energy that can be used to provide for heating materials, potentially for electricity, for fuels and I think the Forest Service clearly owes it to itself and the constituencies it works with to actively explore how we can use these materials to provide for potential future energy resources for the country.

And I think the same goes for NRCS. Clearly, there are all kinds of opportunities with our private forest lands and with the crops that we are growing in this country to address potential markets and opportunities. These are great for conservation. I think they are terrific opportunities for jobs and for rural development. If I am confirmed, I will work very diligently in this effort.

Chairman LINCOLN. I appreciate that and I hope that you will continue to share your vision of how NRCS and the Forest Service can work together to really provide the kind of—private forest landowners with the assistance they need in managing their lands and certainly in terms of the decisionmaking. I know it—often times it definitely takes time, but sometimes expediting that can really be a big help.

I am also from a rural state and a primary concern of mine is the state of rural forested counties. In 2008, we reauthorized the Secure Rural Schools in Communities Act, which helped provide critical funding for schools, roads and forest management that contributed to strengthening the economies of these rural communities.

If authorization expires at the end of 2011, the funds for schools and counties will drop by more than 50 percent, which could be devastating. We had here, well a group meeting yesterday of rural educators basically, but the foresight of that would just be devastating to many of our rural schools across the country. This would be a huge blow to those communities.

Are you familiar, Mr. Sherman, with the SRS and do you support its reauthorization?

Mr. SHERMAN. Madam Chairman, I am not familiar with this program yet, but I promise you that I will become familiar. If I am confirmed I will look into it actively and I will get back to you on that.

Chairman LINCOLN. Please do. There is a disproportionate share of our children in this country that do attend rural schools and certainly that combination of what the Forest Service and others do in those counties and how it affects those schools and the ability to educate our children in rural areas of the Nation is really, really critical.

Last, just maybe you might share with us your experience in Colorado developing the state's roadless rule and how that might affect your handling with that issue nationally?

Mr. SHERMAN. Well first of all, let me just reemphasize my personal commitment to protection of the country's roadless areas. This is an extremely important asset to our current generations and to future generations in the United States. As a personal matter, I believe very deeply in the importance of this resource going forward.

I do want to say that because I was involved in the preparation of a Colorado roadless petition under the Administrative Procedure Act, in my discussions with USDA officials, I think it is appropriate for me to take myself out of consideration of reviewing and rule that I helped to prepare.

So I am sure that the secretary will designate someone else in the department to review the Colorado petition as it comes forward. But the president has stated his very clear desire to protect roadless areas in this country. Secretary Vilsack has as well. I am anxious to sit down with the secretary and his staff to review what strategies and what approaches they will be using going forward.

I have not yet had that opportunity, but I am looking forward to that and if this Committee wishes to talk further about that after

I have had these briefing opportunities, I would be happy to come back and discuss it with you.

Chairman LINCOLN. Thank you. We look forward to many discussions. Obviously, as under secretary of agriculture for Natural Resources and Environment, there is a multitude of issues that are covered there that particularly affect our rural states and they are important. Things that—I will be honest with you, and I do not know how my colleague feels, but I get hit with them every time I go home, which are questions in regard to everything from wetlands and wetlands reserve programs, as well as the rural schools initiatives and other things like that. So those are important issues to our constituents and you will definitely hear from us a great deal in terms of many questions that we will have.

I know my time is running out. I just wanted to touch briefly with Mr. Spearman. As our nation is recovering from financial crisis, there has been much discussion about regulatory reform. We heard it from the previous panel and oversight of the financial institutions.

I certainly strongly believe that the Farm Credit Administration Board needs qualified individuals who can be independent and objective regulators and we look forward to that. If you could share with us your qualifications and capabilities that you would bring to the job to be an independent, objective and conscious regulator of the Farm Credit System and Farmer Mac.

Mr. SPEARMAN. Thank you, Madam Chairman. My experience after graduating from Indiana University was to work for a public accounting firm and as an auditor in a public accounting firm we learned extensively how to actually go into a company, a company that was actually paying you for that job, and to act as an independent auditor.

Following that experience, I moved on to an internal audit position ultimately with Florida's Natural Growers, where I actually worked for Florida's Natural Growers, but my job was to actually put myself outside of the management of the company and to observe the operations, both financially and operationally, as an independent objective auditor.

And moving on to the AgFirst Farm Credit Bank after my retirement from Florida's Natural Growers, I was actually brought on that board as an independent outside director. I do not have farming experience, if you will, other than the experience that I have gotten visiting farms nationally from farmers who have invited my wife and I to experience what actual farm life is like.

So as a result of that, I have—I believe that I can kind of put myself outside and observe the system and act as an effective regulator.

Chairman LINCOLN. I just think it is important to give you the opportunity because as an appointed director—but you did qualify as an independent appointed director on the board?

Mr. SPEARMAN. That is correct.

Chairman LINCOLN [continuing]. Of the AgFirst Farm Credit Bank—to give you an opportunity to really visit about your ability to be impartial in that.

I know our auditors here, whether it is CBO or the JCT and others, as auditors they are non-partisan and certainly not partial.

They just count the beans and tell us how the cow ate the cabbage is basically what they do for us. But it is important as we create legislation to have that and certainly I think it is important to have that independence.

Senator Chambliss.

Senator CHAMBLISS. Thank you, Madam Chairman. Mr. Avalos, as under secretary for Marketing and Regulatory Programs, you are going to be responsible for regulatory decisions, obviously in a very broad arena, including biotech approvals and import standards for agriculture products, such as chickens and other meat products. While sanitary and fido sanitary standards are vital to protect our country from foreign pests and diseases, many of our trading partners use these standards as barriers from time to time to stop our exports.

The biotech issue, GMO issue with our European friends is always a continuing issue and I have had significant debates with the Russians over their, I think, faults presentation relative to fido sanitary issues on import of chicken products, for example. We must ensure that our regulatory system produces decisions that are timely and science based and I simply would like a commitment from you to adhere to science-based decisions and not insert political, social or economic considerations into the regulatory process.

Mr. AVALOS. Madam Chair, Senator, that is a good question. I have spent considerable time in my career working in international trade and I know exactly what you are talking about. I remember back in my early career in New Mexico exporting sheep into Mexico I ran into the same situation, so I can understand where you are coming from.

If confirmed as the under secretary, I will work with Secretary Vilsack and this Committee to look at how we can address these issues with our foreign markets.

Senator CHAMBLISS. Will you commit to using science-based technology to implement regulations?

Mr. AVALOS. Senator, absolutely.

Senator CHAMBLISS. Since Senator Thune is not here to ask it, I will ask you about that non-controversial issue of animal I.D. that I think was first initiated before I was elected to the House 15 years ago, 16 years ago.

What are your thoughts relative to the implementation of the animal I.d. program, since it looks like we have finally come to a conclusion of the legislative process?

Mr. AVALOS. Senator Chambliss, I had a hint that question was coming and I appreciate you asking the question because it is of tremendous interest to me and of tremendous interest to the livestock industry in this country.

Animal I.d. is driven really by the need to trace animal disease. I want to applaud Secretary Vilsack for conducting listening sessions all over the country. I think this was critical, extremely important, to allow stakeholders to come in and provide input, provide their concerns, provide solutions.

Coming from New Mexico, we are a brand state and we have probably one of the toughest brand laws in the country. In New Mexico, we have the ability to quickly and efficiently trace a disease outbreak, so in establishing the disease traceability program,

if you will, I feel that brand states—and of course, comment and input from stakeholders should be considered as important.

If confirmed, I would look forward to reviewing the comments from the listening sessions and look forward to working with Secretary Vilsack and the stakeholders to move forward with this issue.

Senator CHAMBLISS. It is a significant concern to all of our livestock producers and the implementation process is not going to be easy, but I am sure you are up to that challenge. As I have said on numerous occasions before, I am quick to criticize USDA when I think they have not acted properly. But often times, we do not compliment them when they do and both Secretary Venneman and Secretary Johanns had a BSE issue to deal with during their tenure as secretary of Agriculture and the department did not get the credit that it really deserves for the way they handled that. It was done quickly, professionally and did not interrupt our markets.

We are still paying a price on some export markets, but it was not due to the fault or the way that USDA handled that. So this ought to give us an additional tool to work with to try to make the current system, which works well, even better. So we look forward to working with you with respect to that.

Mr. Sherman, I have received about 10 letters and e-mails from Georgians about your appointment and they raise concerns about your approach to managing Federal, state and private lands. I am not going to read those this morning. I would simply like a commitment from you to let me get those e-mails and letters to you and have you address those collectively so that I can respond to those constituents of mine who have raised a concern.

As under secretary for Natural Resources and Environment, you are going to have one of the most—you are going to find that most of your time be spent on dealing with U.S. forest issues and I think you have already addressed that. However, there is another very important part of your job and that is to oversee USDA's work with producers conserving private lands.

American taxpayers invest substantial resources in helping producers help the land each year. By and large, USDA does a good job to provide the NRCS—excuse me, to provide the technical and financial support to do that. But the NRCS is under strain and it is under resourced. Farm Service Agency, which is not under your jurisdiction, has exactly the same problem.

We need to find a way to address the infrastructure needs of the agencies that interact with producers on a daily basis. I would like to know what your thoughts are on recruiting, retaining and supporting NRCS' field staff and meeting the agency's technology needs.

Mr. SHERMAN. Thank you, Senator. Let me just say at the outset, I am very, very excited about the mission of NRCS and I am very impressed by the scope of its work. It is truly remarkable all of the areas, the conservation areas, that this agency is now working in. I have been advised that the agency has some 2,500 offices throughout the United States that are on the ground providing services to ranchers, farms and private landowners.

So I am excited by their mission. I think we need to provide them with the resources they need to get the job done properly. I

met with Chief White the other day for the first time and we had an excellent conversation. So we are going to work very, very hard to continue this effort.

There is some wonderful new opportunities out there for NRCS working with ranches and farms. So I simply give you my commitment that I will work very hard at this. I hope we can have an active dialog with each other about this issue and with this Committee and I am anxious to get on with the job if confirmed.

Senator CHAMBLISS. One other issue that you are going to be faced with right out of the box is an issue that while I represent Georgia is of great concern to me, and that is the issue regarding the plight of the farmers out in San Joaquin Valley in California. It is an issue that certainly involves ESA, which means Secretary Salazar and the Department of Interior may have some primary jurisdiction over part of it. But it does involve farmers in that part of the country.

They have a real significant issue that they have to deal with and I would simply ask that when this does hit your desk, and it will be there the day you are sworn in, that you give immediate attention to that and work very closely with the Department of Interior to let us see if we cannot provide some assistance to those farmers out there who truly are suffering. When you look at the percentage of produce that is delivered to our farmers markets and grocery stores around the country that come from the San Joaquin Valley, it is significant, which means that U.S. agriculture is suffering as a result of that issue.

Mr. SHERMAN. I know Senator Salazar, Secretary Salazar very well and I will look forward to talking to him about that issue.

Senator CHAMBLISS. Mr. Spearman, your nomination to this position at Farm Credit is coming at a critical time in the financial community that both Farm Credit, as well as other financial institutions around the country, deal with. Agriculture, the challenge by the turmoil in the economy, has weathered the storm fairly well.

With your experience with an agriculture cooperative, you have seen ups and downs in agriculture firsthand. How would you compare last year's troubles to past experience? What challenges and opportunities do you see ahead for agriculture and what role do you see the Farm Credit System play in providing financing to producers as they face those current challenges and opportunities?

Mr. SPEARMAN. Thank you for that question, Senator Chambliss. Of course I was not around and working with cooperatives during the eighties, but I have heard a lot of conversation there about the troubles with land prices that the farmers had and the drying up of credit for a lot of those folks who ended up losing their farms and losing their properties.

I think the controls that were put in at that time—the Federal Government did step in and briefly help the Farm Credit System, by which the Farm Credit System has paid all of that money back. I do think that the GSE designation for the Farm Credit System has worked adequately. I think that there is stresses in the industry currently, particularly in the dairy and in the poultry and in some of the livestock industries.

I think the system has procedures and practices in place that is effectively dealing with the problem. Agriculture tends to lag the

commercial industry. I believe that there is adequate capital out there for sound loans to be made and I just think that the industry and the system is postured to continue to have credit for the ranchers and farmers into the future.

Senator CHAMBLISS. Thank you very much, Madam Chairman.

Chairman LINCOLN. Thank you, Senator Chambliss. Just to touch real quickly and there may be others in the Committee that would like to submit questions for the record, so just to give you all a heads up on that and I may actually join them with a couple.

But Mr. Avalos, Senator Chambliss brought up the biotechnology and the importance of implementing a timely and science-based approval process and working through some of those things. I just would stress the timeliness on that. My understanding, that currently the average length of time for agency decisions, making petitions for regulatory approval of agricultural biotech products, has steadily increased and it is alarming to me, I do not know if you mentioned those numbers, but from approximately 150 days in 1996 to almost 700 days at present.

Our hope is, I do not know if you are aware of that big of an increase in terms of delay, but hopefully there will be plans to reduce the current lengthy petition process as it exists. We are going to need to be more competitive than ever in this growing—as we rebuild our economy and the global economy and I think that efficiency is going to be a critical part of how we do that.

So would just like to bring that to your attention and hopefully you can play a role in improving upon that.

Mr. AVALOS. Thank you, Madam Chair. I acknowledge your concerns and if confirmed, I definitely will follow up on this.

Chairman LINCOLN. Well 700 days is an awful long time to go through a process. I do have a few other questions, actually one more just to bring to your attention, Mr. Avalos. There has been a recent, from the USDA, the Animal Plant and Health Inspection Service, APHIS, they are delaying right now for 30 days the implementation of a recently increased—announcement of an increase in fees charged for certain agricultural quarantine and inspection services.

I would like to visit with you more on that hopefully in the future. I think the 30 days may be adequate, but I am not sure that it is going to be adequate in order to make sure that all of those that are participating, whether it is passengers or airlines or others, are going to be able to put that into place as quickly as that may be. So as much as we do not want to delay, we also want to make sure there is adequate time to implement, and so we may be following up with you on that at a later date.

The Committee has also received various letters of support for one or more of our nominees here today and Senator Chambliss, if there is no objection, I would like to make those letters a part of our record. So without objection, that would be so ordered.

[The information referred to can be found on page 216-224 in the appendix.]

Chairman LINCOLN. If there is no other matters that we need to discuss, I have one last housekeeping item. Senators do have until close of business tomorrow to submit any further questions and the record will remain open for five business days in order to give you,

the nominees, the sufficient time you need to respond and we hope that you will be respectful of that as we try to move forward on your nominations. We do need the response to those questions in a timely way.

I want to thank all of you all for appearing before us today and your willingness to serve our government in these capacities. I would also like to take this opportunity to say that we are only as strong as the team that we play on and the Agriculture Committee staff is a phenomenal team. Both the Majority staff and the Minority staff do a tremendous job and I want to personally thank them for helping to make my first hearing a success, in my estimates, and I hope in others'. But they work tirelessly and do a tremendous job on behalf of the Committee.

As I said, it may not be the most glamorous of committees, but it is one that has an unbelievable diversity in terms of the breadth of issues that it covers and the expertise within the staff on the Majority and Minority side are a tremendous asset to the country and I am grateful to all of them for the hard work that they do.

I am still holding out on you, Vernie, but appreciate all of you all for a very historic day for me and one that is very meaningful and I thank you all for participating in it. We appreciate you in offering yourself for service. And a special thanks to my colleague and friend, Senator Chambliss.

With that, the Committee is adjourned.

[Whereupon, at 12:06 p.m., the Committee was adjourned.]

A P P E N D I X

SEPTEMBER 30, 2009

Statement of Senator Thad Cochran

Committee on Agriculture, Nutrition, and Forestry

September 30, 2009

Madame Chairman, I congratulate you on ascending to the chairmanship of this important Committee. Your successful work on behalf of farmers and ranchers is well known and appreciated. I look forward to working with you to review and improve the programs under the jurisdiction of this Committee.

I am pleased to introduce to the Committee Mr. Scott O'Malia who has been nominated by the President to serve as a Commissioner of the Commodity Futures Trading Commission. I have known Scott and worked with him for a number of years, and I believe he is very well qualified for this important position.

Since 2004, Scott has served as a staff member of the Senate Appropriations Committee. Currently, he is the Minority Clerk of the Subcommittee on Energy and Water Development. As Clerk, Scott leads the effort to develop the annual appropriations bills for the Department of Energy, the U.S. Army Corps of Engineers, and the Bureau of Reclamation.

Prior to joining the staff of the Appropriations Committee, Scott served as Professional Staff on the Senate Energy and Natural Resources Committee. His responsibilities included oversight of both energy trading markets and oil and gas production. His previous experience will give him valuable insight into the work of the Commission and other regulatory agencies.

Scott has also gained valuable private sector experience related to corporate risk management. From 2001 – 2003, he worked to establish rules and standards for energy trading among various wholesale power producers.

His experience with energy related policies and activities will provide the CFTC with valuable insight when reviewing energy related financial instruments and regulatory proposals. Scott's knowledge of the Senate and its responsibilities will prove helpful also as we work to exercise oversight of government agencies under the Committee's jurisdiction.

I enthusiastically support the nomination of Scott O'Malia to serve as a Commissioner of the Commodity Futures Trading Commission.

Statement by Senator Pat Roberts
Nomination Hearing
Senate Agriculture, Nutrition, and Forestry Committee
September 28, 2009

Madam Chairman, I want to convey my strong support for the nomination of Jill Sommers to a second term on the Commodity Futures Trading Commission.

Jill is a native Kansan and a graduate of the University of Kansas. She's actually from the picturesque town of Fort Scott, home to the Ft. Scott National Historic Site and National Cemetery.

She is well qualified for this position. Having served on the staff of Senator Bob Dole and worked in several positions in the futures industry, she has the background and understanding necessary to address the difficult issues she will face as a CFTC Commissioner.

More importantly, being from Kansas she understands agriculture and the significant role the CFTC plays in regulating our agriculture markets.

Madam Chairman, the CFTC faces several challenges in bringing additional transparency and accountability to the marketplace while at the same time providing opportunities for producers to better manage their risks.

Thankfully we have high caliber folks like Jill and others who are more than up to the task.

I am proud to support Jill's nomination as a fellow Kansan.

TESTIMONY OF EDWARD M. AVALOS
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman Lincoln, Ranking Member Chambliss, and Members of the Senate Committee on Agriculture, Nutrition, and Forestry, thank you for the opportunity to appear before you today. Also, I would like to thank Senator Bingaman for his kind words and for his efforts in representing the State of

New Mexico. Also, I am extremely grateful to President Obama for nominating me and Secretary Vilsack for his support. With me today is my better half Anna Bee from Mesilla, NM, my daughter Alexandra and her fiancé Tom from Long Beach, California; my daughter Megan and her fiancé Mark, from Phoenix, Arizona; and my son and fishing and hunting buddy, Russell from Las Cruces, New Mexico.

Madam Chair, Members of the Committee, it is an honor to be nominated to serve as the Undersecretary for Marketing and Regulatory Programs at the United States Department of Agriculture (USDA). The mission areas include the Agricultural Marketing Service (AMS), Animal and Plant Health Inspection Service (APHIS) and Grain Inspection Packers and Stockyards Administration (GIPSA). Each of these agencies is extremely important and contributes to benefit the agricultural industry all the way from the producer, through the shipper, processor, retailer, and on to the consumer.

I grew up on a family farm in the Mesilla Valley of Southern New Mexico. At an early age, my parents, Adolfo and Eva Avalos, instilled a strong work ethic which I have followed throughout my professional life. My 30-plus years of experience in agricultural marketing have prepared me for my role as the Undersecretary. I have worked with the agriculture industry to address regulatory, marketing, production, and other issues and challenges in both the national and international arenas. I am a firm believer that the United States (U.S.) agricultural sector has been and continues to be the backbone of this country providing food and fiber to consumers and end users in the U.S. and also to markets all over the world.

During my career, I gained considerable experience in both the international and domestic arena. I have worked to support the production and marketing of livestock, specialty crops, and value-added products through the implementation of trade missions, dialog, and trade promotion.

Also, I've worked with diverse stakeholders to develop, establish and maintain markets for sheep, cattle, goats, and numerous fruits and vegetables in Mexico; onions and processed foods to Canada; and most recently, the pecan grower's success in creating an export market in China.

In the domestic arena, I have been successful in establishing markets for chile, onions, potatoes, watermelons, pumpkins, pecans, beans, and alfalfa. I have worked closely with producers to support the production of crops that the industry demands, with distributors for timely delivery of goods and with retailers to showcase, promote, sell, educate, and inform the consumer

utilizing brochures, recipes, and other promotional and educational tools.

In addition, I have worked to advance Indian agriculture, including working closely with the Navajo Agricultural Products Industry—an 85,000 acre farming enterprise located on the Navajo Nation in the four corners area of New Mexico and with some of the pueblos in Northern New Mexico to bring back traditional agriculture to their tribes.

I believe it is important to create an atmosphere of collaboration and foster good communication throughout agriculture production. I am enthusiastic about opportunities to promote fresh and local availability of products, more farmers markets, and better connecting the American public with their food supply.

As a result, I have established an effective and informative network of growers, shippers, trade organizations, and other stakeholders throughout the country. I've worked closely with the North American Agricultural Marketing Officials, National Association of State Departments of Agriculture, and the Western United States Agricultural Trade Association. This network provides much needed input on issues and trends within the food, agricultural, and livestock industries.

If confirmed as undersecretary for Marketing and Regulatory Programs, I will emphasize providing oversight for the three agencies and addressing the concerns of agriculture boards and commissions. If confirmed, I look forward with enthusiasm to stimulating employee morale and working with the many fine public servants assigned to my area as well as with the other agencies at USDA. I am strongly committed to Civil Rights at the Department and will work hard to ensure USDA's employment practices will not tolerate any form of discrimination, but instead will create a positive environment that celebrates and draws upon the strength of USDA's diverse workforce and customer base.

If confirmed, I am committed and dedicated to working with Secretary Vilsack and this Committee to address and resolve the many concerns and difficult issues facing the food, agriculture, and livestock sectors in this country. Building on my experience with farmers, ranchers, dairymen, shippers, brokers, processors, distributors, retailers, and consumers, I will provide the leadership and guidance needed to implement the farm bill and carry out our mission at USDA.

Thank you for your consideration and I look forward to responding to your questions.

Testimony of Commissioner Bart Chilton
Commodity Futures Trading Commission
Before the
United States Senate Committee on Agriculture, Nutrition, and Forestry
September 30, 2009

Madame Chair, Senator Chambliss and members of the Committee, thank you for the opportunity to be before you, yet again. It's a particular honor to be here today as one of the first witnesses, at the first hearing to be gavelled by the hand of the first woman chair of this Committee in its illustrious 184-year history. There have been 48 chairmen of the Committee since 1825, and some great ones at that—including some Senators who still serve. However, there has never been a woman or an Arkansan as Chair, and I feel very privileged to be here at this moment in history.

I have testified before the Committee each of the last two years. Last year, I gave what I called a "report" on my first year at the CFTC. I'd like to do that now, and like last year, I'll be brief.

The futures industry was not at ground zero of the "crecession"—that is, the credit crisis and the recession. The Commodity Exchange Act (CEA) and the amendments thereto have worked fairly well—as have these markets for most of their more than 150-year history. That said, this is not only an opportune time to look at what we can and should do better, but it is also a propitious time to review how we are moving forward to continue to ensure that these markets are efficient and effective and that we do all we can to avoid fraud, abuse and manipulation.

New Speculators

First, there is still debate about what impact new speculative activity has had in these markets, particularly as we saw a commodity bubble last year. Some say a lot, some say none, some say a little. Here is what I know: approximately \$200 billion went into these markets in the last few years from a new asset class of non-traditional investors. Many of them are what I've called the "new speculators," that is, pension funds, university endowments, state and local governments and index traders who generally take and hold long positions indefinitely. These new speculators are a different phenomenon in the futures markets, which have traditionally been populated by commercial traders—those with a business interest in the underlying physical commodity—and traditional speculators—those who go in and out of the markets, providing liquidity for hedgers, based on their judgments of price movements. The new speculators have a different *modus operandi*. They get in the markets, by and large, and stay there—most of the time regardless of price. They are passive long traders who are betting that the price of a commodity will be worth more in a time certain—say five years—than it is today. They don't alter their trading strategy on daily prices or other information coming into the markets—this is

sometimes referred to as being “price insensitive.” As regulators, we need to be aware of the potential effects and activities of these new participants in the markets, and what their impact may be on traditional market users and the primary functions of the futures markets, that is, price discovery and risk management.

My take on this is that the new speculators have had an impact. That impact was likely divorced from the fundamentals of supply and demand, and has effected farmers putting seed in the ground, consumers and businesses putting gas in their cars and trucks, and families putting food on their tables. I’m not suggesting that the new speculators are necessarily the primary “drivers” of commodity prices, but I think they have had an impact. So, what do we do, as regulators, with that?

Under the Commodity Exchange Act (CEA) Section 3, a fundamental mission of the CFTC is to guard against fraud, abuse and manipulation. That means taking some precautions. In my mind, we need to do this in a way that doesn’t roil markets and that doesn’t send trading to less regulated venues or to overseas trading platforms.

Position Limits/Hedge Exemptions

Given the amount of volatility we’ve seen over the last two years in commodity prices, it makes sense for us to review limits on the amount of positions that traders can hold and also to look at exemptions to those limits. We have had position limits in the agriculture commodities since the 1940s, and they seem to have worked pretty well (although we have certainly seen some significant hiccups in the last two years). I don’t know why appropriate position limits wouldn’t make sense in the other physical commodity markets, specifically, energy and metals. That’s one of the benefits of principles-based regulation: it allows us to innovate, bring something new and needed to markets as we see it’s required. We certainly need to strike the right balance, but since our obligation under the law is to guard against, among other things, manipulation, this seems like an appropriate course to pursue.

The Commission is currently considering what appropriate action(s) we can take in this regard and I commend CFTC Chairman Gensler for holding a series of hearings this summer on these specific topics.

Whatever we do, or don’t do for that matter, we need to account for the markets we don’t observe. The CFTC does not have a full-landscape view of the derivatives markets and as a result, we cannot protect consumers as we should. The over-the-counter (OTC) markets are comprised of billions upon billions of dollars of unregulated trading. This is where credit default swaps began trading, metastasized among traders, and then played such a significant part in the recession. All of these trades were done out of the view of regulators. I do care about larger OTC trading that could have an impact upon the currently regulated exchanges, or upon price. I care about OTC look-alike contracts traded on exempt platforms—just as I care about look-alike contracts on Foreign Boards of Trade (FBOTs). I don’t know that as a regulator, however, just how much I should care about insignificant bilateral trades between say, a grain elevator and a large producer, if that transaction doesn’t affect commodity prices or extend beyond local commerce. But as I say, I’d like more of a panoptic view of all markets, and that means looking

at OTC trades in some significant fashion. It also means having regulatory and enforcement authority over these currently unregulated markets.

The Commission is currently considering what we can do, in appropriate fashion through our rulemaking, on position limits and hedge exemption. Whatever we do, assuming we do anything, we need to do that with an eye toward the OTC markets. Some have suggested that if we impose position limits on the regulated exchanges that the trading will simply move to the OTC markets or overseas. That is a good point, and whatever we do needs to be done in light of what the Congress may do with regard to OTC trading as part of a regulatory reform measure. While I do not think that the CFTC must wait on Congress to act on regulatory reform, I do believe we need to be cognizant of the entire environment in which we are operating and ensure that whatever we do doesn't have a perverse impact on markets, traders, or most importantly, upon consumers.

Manipulation

The issues I've addressed have been the subject of many hearings and written about in the news media, but they are important so I wanted to mention them once again. There are, however, three other issues I wanted to raise that have not received as much attention.

First, I think Congress—and specifically this Committee—should seriously consider changing our manipulation standard. It's an opportune time to address this, inasmuch as you have the issue of financial regulatory reform on your agenda. Just a few weeks ago, we had two days of hearings with the Securities and Exchange Commissioner (SEC). These were historic in that the Commissioners of the two agencies had never met in a public setting before. They were long overdue given the myriad issues of mutual interest between the two agencies. One issue that I highlighted (and our Chairman also raised questions on this point), is the varying manipulation standards. If you compare the agencies' manipulation standards, the SEC has an easier legal hurdle to jump, and I think this may be a great opportunity to adjust our standard to be more in line with theirs, particularly in light of the Administration's call that our agencies harmonize our rules and regulations. The Federal Energy Regulatory Commission (FERC) and the Federal Trade Commission (FTC) have standards similar to the SEC's manipulation standard.

To be more specific, under applicable case law the CFTC is required to prove "specific intent" to manipulate. That is a very difficult standard to reach, not to mention that it leaves a lot of wiggle room for mischief that is clearly prohibited by the Act, yet not categorically outlawed. It would be extraordinarily unlikely that any individual, for example, would explicitly write in an e-mail that he or she specifically intends to manipulate prices. But that's what our law currently requires. In fact, this standard is so high that in the CFTC's 35-year history, while we have settled numerous manipulation cases, we have only successfully prosecuted and won one single case of manipulation in the futures markets! Only one. And that case, the DiPlacido matter, is currently on appeal in federal court.

In addition, our case law requires that we prove an artificial price exists, that the defendant had market power to move the price, and that he or she actually did cause the artificial

price. Particularly in today's complex markets, proving "artificial price" can be a daunting task, which more often than not comes down to a "battle of the experts" in court. Because these requirements are so onerous, we often end up moving to a lesser charge of "attempted manipulation," which requires only proving intent and some act showing that intent. This is still a high standard, but is much easier than proving up a full manipulation case. Again, we've been very successful over the years, particularly in the energy arena, in obtaining significant settlements in attempted manipulation cases, but we've not had success in litigated cases because of our very difficult manipulation standard.

The Securities and Exchange Commission (SEC), on the other hand, under its "10b-5 rule" has a different, easier-to-prove manipulation standard. Basically, they are not required to prove specific intent, as we are, they just must prove that the defendant acted "recklessly." I'm not saying that the answer is wholesale adoption of the SEC manipulation standard, but clearly, as Senator Cantwell and others have recently noted, we need to do something different at the CFTC. The status quo simply isn't good enough.

A recent federal court case in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of \$303 million—the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that case by bringing a criminal case against four of the participants in the scheme. Two weeks ago, the Texas judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met. Clearly, the current standard is not working.

I would point out that, in looking at other jurisdictions around the world, virtually all nations have rules prohibiting this type of conduct, and it is a criminal offense in many of those jurisdictions, entailing significant sanctions. In this country, our current standard in the futures arena is ineffectual. It is not sufficient to fully prosecute and deter abuses in the markets, and I'm hopeful that in working with Congress, we can all move forward on figuring this out.

Criminal Authority

Another issue that I think deserves more attention—related to our manipulation standard and enforcement efforts—is criminal authority. Neither the CFTC nor the SEC, the two principal federal financial regulators responsible for policing the exchange trading markets in the United States, has legal authority to put bad guys in jail. Both have authority to bring cases in federal court against fraudsters and scam artists, but the only penalties in their regulatory arsenals are civil—monetary fines, for example. The Federal responsibility for putting people behind bars is reserved, currently, for DOJ. And the reality, unfortunately, is this: it is becoming tougher and tougher to incarcerate felons because of a lack of legal authority—criminal authority—for financial regulators.

Violations of commodities and securities laws often involve highly technical and complicated trading schemes. To prosecute these violations effectively, attorneys and investigators must be experts in the complex functioning of these markets. SEC and CFTC

enforcement personnel are specially trained to handle these matters, unlike DOJ prosecutors who are more likely to be unfamiliar with the mechanics of financial trading and the interstices of federal financial laws and regulations. That doesn't mean that there aren't very qualified DOJ attorneys who understand futures law. There are some, but not enough. While DOJ attorneys do an excellent job in their prosecutorial functions, it is simply asking too much to expect them to be expert in the types of complexities that commodities and securities professionals deal with on a daily basis. It is perhaps understandable why it is difficult to get them to commit scarce resources to prosecute complicated financial fraud and manipulation cases.

Since 2002, the CFTC has referred over 100 cases to DOJ and other criminal authorities (such as state and local law enforcement bodies). Unfortunately, two-thirds of those criminal referrals have been rejected. One might think that we aren't sending them good criminal cases, but that's not the situation. In fact, in 100 percent of those matters, the CFTC moves forward and we reach a favorable outcome for the government.

The bottom line is that folks who do the crime often only pay the fine and don't do the time. Other financial regulators around the world—in the United Kingdom, Australia, Hong Kong, and Japan, for example—already have such criminal authorities. Chairman Peterson of the House Agriculture Committee has taken a leadership role on this issue, resulting in passage by his Committee of a provision that would grant the CFTC such authority. I understand that this raises jurisdictional issues—both in Congress and with DOJ. Perhaps there are good reasons that this should not be done. So far, I haven't heard those reasons. I have heard that, "It has never been done." I have also heard that, "Only DOJ should handle such cases since they are the Executive Branch." But, what are we? The CFTC is part of the Executive Branch. Granted we are an independent agency, and perhaps that raises issues that cause some concern. Again, however, I haven't heard a good argument against this proposal. Certainly, I'm hopeful that congress will consider this change.

Consumers

Finally, I think the Commission needs to revitalize its commitment to educating, protecting and advocating for the investing public. The futures markets of today are not the same as they were even three years ago, and that is, in part, due to new participants. With the advent of new and novel products, and the recession, the investing public are now moving their assets into the futures markets with exponential momentum, and they are sometimes doing so without full and complete understanding of the nature of the investments or strategies.

The CEA specifically empowers the CFTC to engage in education and outreach efforts to protect market participants from fraudulent and other abusive sales practices, and I am committed to a renewed effort to provide consumers with information they need and want regarding financial investing. We need to become a more user-friendly public resource for investors and prospective investors. Only through increased financial literacy will the investing public be better able to navigate the investment choices currently before them. I'm committed to providing this resource to American consumers to provide the protections and information they need and deserve.

Thank you for the opportunity to be with you today. I'd be pleased to answer any questions at the appropriate point.

STATEMENT OF SCOTT D. O'MALIA
Before the
United States Senate Committee on Agriculture, Nutrition and Forestry
September 30th, 2009

Madame Chairman, Ranking Member Chambliss and members of the Committee thank you for the opportunity to testify today. Madame Chairman, I would like to congratulate you on becoming Chairman of this Committee.

I am grateful to appear before you as President Obama's nominee to serve as a Commissioner to the Commodity Futures Trading Commission (CFTC). I would like to thank Senator Bennett for his support and willingness to introduce me to the Committee. As a Michigan native, I would also like to thank Senator Stabenow for her support as well.

Before, I begin I would like to introduce my family. I am joined by my wife, Marissa and three daughters Kelsey, Claire and Macey. I would also like thank my parents, John and Bev O'Malia, for joining me here today. I would not have this opportunity today if it were not for the support of my wonderful family.

I am honored to be nominated by the President to serve as a Commissioner to the Commodity Futures Trading Commission. Given the fact that this country has experienced the worst financial meltdown since the great depression, I recognize the enormous responsibility of this office.

Like everyone in this nation, I too have lost value in my home, retirement and college savings. I am sensitized to the hardship this crisis has caused families across the country. This experience reinforces my strong belief that our nation's financial regulators must be vigilant in their oversight responsibilities to ensure transparency and accountability in our markets. Furthermore, regulators must recognize the inherent risk associated with the trading products which have contributed to this crisis and they must commit to doing all they can to maintain stability and security of our financial markets.

I believe the oversight of our financial institutions and markets must be strengthened. I am committed to exposing the underlying risk and trading practices that might further destabilize our economy with serious impacts on our financial, energy and agriculture markets. The stability of our futures and commodities markets require that trading occur among reliable parties with as much information as possible. I am also concerned that extensive leverage and uncertain collateral values could destabilize these markets.

Madam Chairman, for the past six years, I have worked in the Senate serving on the Senate Energy and Natural Resources Committee and the Senate Appropriations Committee. During this time, I have focused my work on energy policy with the goal of reducing our nation's dependence on foreign energy resources and expanding U.S. investment in clean energy technologies, including improving the effectiveness of the Department of Energy's Loan Guarantee program.

Over the past three years, the Energy and Water Subcommittee has authorized and appropriated over \$50 billion worth of self-financed loan guarantees and invested tens of billions of dollars into research and development to support the deployment of clean energy technology.

Transformation of our energy sector requires more than federal research assistance. It requires billions of dollars in new investments that will occur only if investors believe energy markets are stable, provide reliable price transparency and offer the opportunity to hedge their commercial risk.

Prior to joining the Senate Energy Committee, I spent two years in the electricity sector. This experience provided an invaluable education regarding the devastating impacts a flawed market design and illegal trading behavior can have on consumers. As a result of this experience, I am resolved to prevent this catastrophe from being repeated.

I joined Mirant in February 2001, as a director of federal affairs focused on federal energy policy. I did not work for a trading desk or for a business unit that managed generation assets. By the time I arrived, it was already apparent the California electricity market was dysfunctional. California had experienced a difficult summer with record energy prices and blackouts in June, 2000. By November 2000, FERC had determined that the California market was flawed, making it possible for manipulative trading behavior to cause an imbalance in supply and demand that made electricity rates unjust and unreasonable.

In response to the trading behavior uncovered in 2001, I worked with Mirant's Chief Risk Officer and five other energy companies to establish the Committee of Chief Risk Officers (CCRO). This organization was created to prevent and avoid the trading abuses used by some in the industry to manipulate the California and Western energy markets.

The CCRO established industry wide trading protocols, improved price disclosure, required clearing and standardized contracts and imposed a corporate trading code of conduct. These standards would give regulators, consumers and investors a better view into the business and operations of these companies.

I do recognize that many of the same reforms implemented by the Committee of Chief Risk Officers are now embodied in the financial overhaul proposed by the Administration, but on a larger scale. Both efforts seek to improve transparency of Over-the-Counter markets, reduce systemic risk and set trading standards to reduce opportunities for excessive speculation and manipulation. A key component of both efforts has been the utilization of clearing to reduce counterparty risk and allocate capital more efficiently.

My experience reaffirms my strong belief that regulators are critical in ensuring that markets operate in a fair and transparent manner. To achieve this, regulators must be provided with the appropriate authority and tools to respond to the constant evolution of market behavior and products.

As I stated in the beginning, I am sensitive to the impacts the financial crisis has had on families across the country. I also understand the consequences to all of us if markets, which are designed to offer protection from risk, are manipulated and thereby expose our financial system to greater peril.

Drawing on my extensive energy background, I believe I can make a significant contribution to the Commission. If confirmed, I will work with the other Commissioners to ensure markets continue to offer consumers and producers the opportunity to cost-effectively hedge their commercial risk and facilitate the dissemination of timely and accurate market price data. I will work to ensure the CFTC uses all of its legal authorities to curb excessive speculation and prevent abusive trading practices, including fraud and manipulation.

I would like to thank the Committee for holding this hearing and considering my nomination. It would be an honor and a privilege for me to serve as a Commissioner to the CFTC.

Madam Chairman, I would be pleased to answer any questions.

Thank you.

Opening Statement for Harris Sherman, Nominee for Undersecretary for Natural Resources and the Environment, United States Department of Agriculture

Thank you Madame Chairman. It is a great honor to appear before this Committee regarding my nomination for the position of Undersecretary for Natural Resources and the Environment at USDA.

And Madame Chairman, it is also a great honor to be present today at this historic proceeding where you assume the Chairmanship of this crucial Committee. If confirmed, I very much look forward to working with you in your new capacity and with all the members of this Committee.

Several weeks ago when I received the news that President Obama had nominated me for this position, I was deeply humbled by the honor but also by the degree of responsibility that accompanies the position. I fully realize that the challenges ahead will not be easy but it is an extraordinary opportunity to do good things for our country. If confirmed, I promise to use my strengths, energy, commitment, and good judgment to advance the conservation and public land programs that will fall under my jurisdiction. And I promise to work closely with you and the other committees of Congress as we go forward.

My interest in overseeing the Forest Service and NRCS stems from a lifetime of experiences with public lands and conservation programs. As a child, my parents took me to the mountains outside Denver where we would camp, hike, fish, ski, and jeep. These experiences left an indelible impression on me about the grandeur and importance of our national forests. Later, I twice have had the privilege of serving as Colorado's Director of Natural Resources for two different governors where I have worked on a daily basis with the Forest Service and other federal agencies on complex, challenging resource issues. And between these two stints as DNR director I have represented as an attorney both public and private sector clients in their dealings with federal land management agencies. These experiences, combined with my earlier work with the State Soil Conservation Service and my later work with many land trust conservation organizations, have given me a background that I believe will serve me well in meeting the Forest Service's mission.

Looking forward, there are tremendous challenges regarding our forests, both federal and private, and the conservation programs associated with farms and ranches throughout the country. On the forestry side, many forests are in trouble due to past fire suppression, increasing fuel loads and changes to our climate. As a result, many forests are far more vulnerable to catastrophic fire, disease and invasive species, often in epidemic proportions. We are witnessing far more frequent, intense fires than we have seen in the past. Combining these factors with a growing human population influx within or adjacent to our public and private

forests, it is clear that we have a very challenging situation ahead. How we protect our growing communities from fire danger; protect the watersheds within our forests that supply drinking water to much of our population; protect wildlife species that rely centrally on these forests; and insure that our forests play a critical role as carbon sinks is a herculean responsibility. I believe that Secretary Vilsack's emphasis on restoration of our forests, both federal and non-federal, in a manner that addresses climate change, environmental protection, identifies new markets for wood products, creates jobs, and sustains rural communities provides an excellent framework for moving forward.

It is also important that we take a holistic approach to land conservation issues and fully integrate our approach to both public and private working lands. On the NRCS side of the ledger, I have much to learn but I am excited by the mission and scope of the Agency's charge. Conservation on private working lands plays a significant role in protecting water resources and wildlife habitat, creating jobs through market-based conservation opportunities and providing economic opportunities for rural America. NRCS's watershed protection programs help protect communities from floods – like those we just saw in Georgia. With its comprehensive programs, on-the-ground expertise and powerful technical tools, NRCS is well positioned to help private landowners play a significant role in addressing a variety of the nation's conservation challenges.

Together the Forest Service and NRCS can make a major difference. Never before have agriculture and forestry been more at the forefront of current national policy issues. This is an urgent time to make progress. I am excited by the prospect of devoting my energies to these tasks. I promise you that, if confirmed, I will undertake collaborative efforts involving appropriate stakeholders to find common sense solutions and to come up with answers that will withstand the test of time, becoming durable, longstanding, reliable programs.

Thank you.

**Statement of Commissioner Jill E. Sommers
Before the United States Senate
Committee on Agriculture, Nutrition and Forestry
September 30, 2009**

Chairman Lincoln, Ranking Member Chambliss and other members of the Agriculture Committee, I am honored to be nominated by President Obama for another term as a Commissioner at the Commodity Futures Trading Commission (CFTC). I have been in this position since August of 2007, and it has been a true privilege to serve the American public as a regulator of the U.S. commodity futures and options markets.

During my career, I have had the opportunity to work on Capitol Hill for Senator Bob Dole, for a regulated derivatives exchange, as well as for the trade association representing participants in the privately negotiated derivatives industry. I believe this unique experience gives me a diverse view of risk management issues and the knowledge to help implement our core mission at the CFTC.

Since 1974, that mission has been to protect market users and the public from fraud, manipulation, and abusive trading practices related to the sale of physical and financial futures and options, and to foster open, competitive, and financially sound markets. The agency endeavors to ensure the fairness, efficiency, and economic utility of the markets through a strong regulatory oversight program that includes market surveillance to detect and prevent manipulation and other market disruptions as well as ensuring the financial integrity of the clearing process. This risk-tailored approach to regulation is also complemented by strong enforcement as evidenced by over \$2.8 billion worth of penalties and restitution assessed in actions brought by the CFTC since the year 2002.

Through effective oversight, we facilitate the important hedging and price discovery functions that the futures markets were designed to serve. This regulatory regime has enabled the futures industry to experience enormous growth over the past decade. In FY 2000, the U.S. exchange traded volume was 580 million contracts. In FY 2009, the volume is 2.8 billion contracts, which is a 383% increase. Even with that growth, the regulated futures industry did not endure the loss of any customer funds during the current economic turmoil due to the default or failure of a futures commission merchant (FCM).

Although the regulated futures exchanges and FCMs have performed well throughout the financial crisis, there is a widespread belief that the CFTC's regulatory authority should be extended to cover the trading of over-the-counter (OTC) derivatives. There is broad consensus that more transparency must be brought to these markets. The current Commission is unified in support of comprehensive regulatory reforms including full regulation of the over-the-counter markets (OTC). This regulatory framework would cover both OTC derivative dealers and the OTC derivative markets in which they trade.

I believe we need to enhance transparency and close regulatory gaps to achieve improvements in the regulatory structure. To that end, the CFTC has undertaken a number of initiatives over the past year to strengthen our regulatory oversight and

thereby enhance public confidence in the markets we regulate. There is no doubt that public confidence in the markets is crucial. Unless the public is assured that the markets are operating efficiently and are free from abuse, commercial producers and users of the commodities underlying futures transactions will be reluctant to use the markets to hedge their price risks, and the information they would otherwise bring to the markets—which is essential to discovering accurate prices—will be lost. We must strive to bolster that confidence and strengthen market integrity. As decision makers, it is our job to implement prudent government solutions. The CFTC has a responsibility to achieve these objectives, and if reconfirmed, I look forward to continuing to ensure this responsibility is met.

Under the leadership of Chairman Gary Gensler we have taken several steps recently to fulfill those objectives. First, the Commission held three days of hearings in July and August to review the application of and exemptions from position limits for futures contracts involving physical commodities, with a particular focus on energy commodities. We heard from almost thirty witnesses with very diverse points of view. Second, together with the Securities and Exchange Commission, the CFTC held two days of joint public meetings the first week of September to discuss issues of regulation harmonization. The two agencies have been asked by the Administration to identify conflicts in how we regulate similar financial products and to either explain why those differences further important policy goals, or make recommendations for resolving differences where they do not. And finally, on September 4, we implemented two new transparency measures by further disaggregating our Commitments of Traders (COT) report and publishing an updated report, Index Investment Data, based on the information we have been receiving since June of 2008 through our special call authority.

The questions surrounding these issues are enormously complex and require thoughtful resolutions. Our staff is working very hard to provide recommendations on these as well as a number of other important initiatives. I want to take this opportunity to salute the dedicated men and women at the CFTC who serve the American public and the futures industry with great distinction. I am very proud of their work and know they will do an outstanding job implementing any recommendations for enhancing and harmonizing the regulatory framework.

Not since the Commodity Exchange Act and the securities laws were passed in the 1930s has there been a time when events have coalesced, as they have over the past year, to bring into such sharp focus the need for harmonizing regulation and closing regulatory gaps. As a commissioner at the CFTC, I believe there is a historic opportunity to reshape the regulatory oversight of financial markets. It is a very challenging time for the Commission and I am committed to strengthening regulation where needed and eliminating inefficiencies where possible. If confirmed by this Committee and the United States Senate, I will work hard to ensure that the CFTC continues its role of protecting the integrity of the markets while addressing concerns about the regulatory structure. It is the responsibility of the Commodity Futures Trading Commission to defend the crucial risk management and price discovery functions provided by our commodity futures and options markets.

**Testimony of
Kenneth A. Spearman
Before the
Senate Committee on Agriculture, Nutrition, and Forestry
September 30, 2009**

Thank you, Chairman Lincoln, Ranking Member Chambliss, and the distinguished members of the committee. Senator Lincoln, congratulations on assuming the Chairmanship of the Committee. I look forward to your leadership and to working with you, Senator Chambliss, and this committee for the betterment of American agriculture.

I also want to thank Senator Nelson for his kind and generous introduction. He serves my home state of Florida in the United States Senate with honor and distinction. If confirmed, I will keep the trust of his example of public service to our Country.

It is a privilege to appear before you today as President Obama's choice to serve as Board Member of the Farm Credit Administration. This is a special day for me and I am honored that my family is here to share it with me. We all achieve success in life with the help of others. I'm no exception, so I especially want to acknowledge my wife, Maria, my twin daughters, Michelle Springs and Rochelle Puccia, and my son, Dr. Kenneth Spearman.

It is indeed an honor to be nominated to this prestigious position. I would like to share my background and tell you about the skills and experience I would bring to the Farm Credit Administration Board, should the committee confirm my nomination.

As an accountant, I was involved with the development of a public accounting firm in Chicago, Illinois, and later worked as an accountant for a major accounting firm. From 1980 to 1991, I served as Controller of Citrus Central, Inc., where I was responsible for financial management and reporting for this \$100 million agricultural cooperative. Until recently, I was the Director of Internal

Audit for Florida's Natural Growers, Inc. There I was responsible for the design and implementation of the annual plan, which was used to appraise the soundness, adequacy, and application of accounting, financial and other internal operational controls. I currently serve as an independently appointed, outside Director on the Board of AgFirst Farm Credit Bank, a position I've held since January 2006.

As you can see by my professional history, most of my career has been spent working for agricultural cooperatives. During my 28 years in the citrus industry, I gained a deep appreciation for agricultural producers and production agriculture.

As the members of the committee are well aware, production agriculture, particularly Florida's citrus industry, is capital intensive and heavily reliant on access to competitive credit. Add in variables of the marketplace, world events, weather, and many other unforeseen factors and one can see that agriculture is a risky business. Americans and, for that matter, people around the world should be thankful for the men and women who produce the food and fiber that we enjoy daily and without which we could not survive.

As I said, production agriculture is very capital intensive. Land costs, labor, equipment, and fertilizer require long-term and short-term financing. It takes a variety of lenders to meet the credit needs of agricultural producers and their cooperatives. The Farm Credit System, which is regulated by the Farm Credit Administration, is a very important part of the coalition of lenders required to finance American agriculture.

Serving as an outside Director of the AgFirst Farm Credit Bank Board has given me a new and greater appreciation for the complexity and importance of agricultural and rural finance. I believe my 28 years of financial experience working for agricultural cooperatives would serve me well as a member of the board of the Farm Credit Administration. I would utilize that expertise to ensure the safety and soundness of the Farm Credit System so that it continues to serve the credit needs of America's farmers, ranchers, and their cooperatives.

In closing, I would like to thank the Committee for the important role it plays in the oversight and authorization of the Farm Credit System and its mission to meet the credit and related services needs of American farmers and ranchers.

That concludes my statement. I welcome your questions.

Thank you.

DOCUMENTS SUBMITTED FOR THE RECORD

SEPTEMBER 30, 2009

(67)

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used). Edward Mesa Avalos
2. Date and place of birth. November 8, 1951; Dinuba, CA
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es). Divorced
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

 New Mexico State University, College of Agriculture 1970-1974
 B.S. Agronomy 1974; B.S. Horticulture 1975;
 New Mexico State University, College of Agriculture 1995-1996
 M.A. Agriculture 1996.
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

 Texas Department of Agriculture, 1975-1980
 Amarillo, Texas
 Marketing Specialist

 New Mexico Department of Agriculture, 1980-present
 Las Cruces, New Mexico
 Director of Marketing
 Ag Marketing, Sales, and Promotion

 Eddards Construction, Inc. 1987-present
 Las Cruces, New Mexico
 Residential Construction-Construct 2-5 houses per year.
6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

 None
7. Government Service: State (chronologically) your government service or public

offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

None

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

Best Ag Marketing Project 2007-New Mexico Green Chile, North American Agriculture Marketing Officials (NAMO)

9. Other Memberships: If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

New Mexico State University Aggie Athletic Fund
Served as a board member from 2006-2007
Purpose was to raise support and funding for Aggie Athletics

Advisory Board, New Mexico State Land Office
Have been on the board since 2006. I will resign when confirmed. My role on the advisory board was to represent beneficiaries and relay their concerns, if any, to the Land Office.

Fraternal Order of Eagles, Member

New Mexico Cattle Growers Association, Associate Member

10. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

None

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes
2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None
3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)

No
4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in federal commodity income and price support programs? (If yes, provide all details including amounts of government payments and loans received or forfeited by crop and farm, et cetera during the past five years.)

No
5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any current or previously existing agency of the Department of Agriculture, including through any of the farm or rural development lending programs? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)

No
6. Have you, or any partnership or closely held corporation in which you have an interest, received payments for crop losses from the federal crop insurance program in the past 5 years? (If yes, give details.)

No
7. Have you ever received a government guaranteed student loan? If so, has it been repaid?

No

8. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No, if confirmed, I will resign as president of Eddards Construction, Inc. My son, Russell Avalos, will operate and manage the small construction company.

9. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No

10. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No

11. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

None

12. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above items. In particular, identify all investments, obligations, liabilities, or other relationships which involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

I do not see any actual or potential conflicts of interest. In connection with the nomination process, I have consulted with the Office of Government Ethics and the Department of Agriculture's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.

13. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or

potential conflicts of interest should you be confirmed to the position for which you are nominated.

In connection with the nomination process, I have consulted with the Office of Government Ethics and the Department of Agriculture's designated agency ethics official to identify potential conflicts of interest. Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

July 7, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Edward M. Avalos, who has been nominated by President Obama for the position of Undersecretary for Marketing and Regulatory Affairs, Department of Agriculture.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert J. Cusick".

Robert J. Cusick
Director

Enclosures

June 24, 2009

Mr. Raymond J. Sheehan, Director
USDA Office of Ethics
1400 Independence Avenue, SW
Rm 347-W J. L. Whitten Building
STOP 0122
Washington, DC 20250-0122

Dear Mr. Sheehan:

The purpose of this letter is to explain the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Under Secretary for Marketing and Regulatory Programs, U.S. Department of Agriculture. As Under Secretary of Agriculture for Marketing and Regulatory Programs, I may also hold a general membership on the Board of Directors of the Commodity Credit Corporation. The steps detailed below take into account any potential conflicts or appearances thereof associated with the Commodity Credit Corporation position also.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to section 208(b)(1), or qualify for a regulatory exemption, pursuant to section 208(b)(2). I further understand that the interests of the following persons are imputed to me: any spouse or minor child of mine, any general partner of a partnership in which I am a limited or general partner; any entity in which I serve as officer, director, trustee, general partner, or employee; and any person or entity with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position as Director, Marketing and Development Division, New Mexico Department of Agriculture. For one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the New Mexico Department of Agriculture is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

As an employee of the State of New Mexico Department of Agriculture, I currently participate in a defined benefit retirement plan operated by the New Mexico Educational Retirement Board. Upon termination of my employment relationship, my employer will cease making contributions to this plan. Under this plan, I am to receive \$4,692 per month beginning at age 57. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of New Mexico Educational Retirement Board to provide this employment benefit, unless I first obtain a written waiver pursuant to 18 U.S.C. § 208 (b)(1) or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208 (b)(2).

I also am owner and President of Eddards Construction, Inc., of Las Cruces, New Mexico. Upon confirmation, I will resign my position as President of the company. I will continue to have a financial interest in this entity, but I will not manage it or provide any other services to it. Instead, I will receive only passive investment income from it. Pursuant to 18 U.S.C. § 208 (a), I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the financial interests of Eddards Construction, Inc.

I also own four rental residential properties and one parcel of undeveloped land, all located in Las Cruces, NM. Pursuant to 18 U.S.C. § 208 (a), I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the value of these properties. Additionally, the rental properties are subject to mortgages and the undeveloped lot is subject to a repayment of a personal loan from the following entities, all located in Las Cruces, New Mexico:

- Sun Trust Mortgage
- Bank 34
- Bank of the Rio Grande

Pursuant to 5 C.F.R. § 2635.502, I will not participate personally and substantially in any particular matter involving specific parties in which any of these entities is a party or represents a party, unless I am authorized to participate.

As part of my duties as a New Mexico State employee, I also serve as Vice Chairman of the New Mexico State Land Office Advisory Board (Board). Upon confirmation, I will resign from the Board. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Board is a party or represents a party, unless I am first authorized to participate pursuant to 5 C.F.R. § 2635.502(d).

Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,



Edward M. Avalos

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | | |
|---|---|--|---|--|--|
| Date of Appointment, Candidacy Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate boxes) <input type="checkbox"/> Incumbent <input type="checkbox"/> Calendar Year Covered by Report <input checked="" type="checkbox"/> New Hire, Nominee, or Candidate <input type="checkbox"/> Termination <input type="checkbox"/> Termination Date (If Applicable) (Month, Day, Year) | Reporting Individual's Name Last Name: Avalon First Name and Middle Initial: Edward M. | Position for Which Filing Title of Position: Undersecretary for Marketing and Regulatory Programs Department or Agency (If Applicable): Agriculture | Location of Present Office (or forwarding address) Address (Number, Street, City, State, and ZIP Code): Duplicate Telephone No. (Include Area Code): | <p>Reporting Periods Termination Filers: The reporting period is the preceding calendar year except for II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable.</p> <p>Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable.</p> <p>Nonincumbent, New Entrants and Candidates for President and Vice President: Schedule A - The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value dates as of any date you choose that is within 31 days of the date of filing.</p> <p>Schedule B - Not applicable.</p> <p>Schedule C, Part I (Initiation) - The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 91 days of the date of filing.</p> <p>Schedule E - Part II (Assessments or Arrangements) - Show any assessments or arrangements as of the date of filing.</p> <p>Schedule D - The reporting period is the preceding two calendar years and the current calendar year up to the date of filing.</p> <p>Agency Use Only</p> <p>Office Use Only JUN 25 2009</p> |
| Presidential Nominee Subject to Senate Confirmation Name of Congressional Committee Considering Nomination: Agriculture, Nutrition, and Forestry Do You Intend to Create a Qualified Discarded Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | <p>Comments of Reviewing Officials (If additional space is required, use the reverse side of this sheet) (Check box if filing extension granted & indicate number of days) <input type="checkbox"/></p> <p>(Check box if covered by a filing extension) <input type="checkbox"/></p> | | | | |
| <p>Signature of Reporting Individual Signature: Edward M. Avalon Date (Month, Day, Year): 6/24/09</p> <p>Signature of Other Reviewer (If desired by agency) Signature: [Signature] Date (Month, Day, Year):</p> <p>Signature of Designated Agency Ethics Official/Reviewing Official Signature: [Signature] Date (Month, Day, Year): 6/26/09</p> <p>Office of Government Ethics Use Only Signature: [Signature] Date (Month, Day, Year): 7/7/09</p> | | | | | |

76

Edward M. Azusa

SCHEDULE A continued

2

(Use only if needed)

| BLOCK A | BLOCK B | | | | | | | | | | BLOCK C | | Other income (do not check any boxes) | Date (M., Day, Yr.) | Date of Reacquisition | |
|---|--|-------------|------------|-------------|--------------------|----------------|--------------|-------|--------------------------|--------------------------|--|--------------------------|---------------------------------------|--------------------------|--------------------------|--------------------------|
| | Valuation of Assets at close of reporting period | | | | | | | | | | Income type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for this item. | | | | | |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | | | | |
| | Other | Real estate | Securities | Partnership | Private foundation | Art collection | Collectibles | Other | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 | None for less than \$201 |
| <input type="checkbox"/> None | | | | | | | | | | | | | | | | |
| New Mexico Education Endowment Board | | | | | | | | | | | | | | | | |
| United Methodist Church | | | | | | | | | | | | | | | | |
| Undeveloped lot in Concord, NM | X | | | | | | | | | | | | | | | |
| Edwards Construction, Inc. in Concord, NM | X | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other block boxes "None for less than \$201" as appropriate.

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: Edward M. Avalos

SCHEDULE B

Page Number: 3

Part I: Transactions

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGR.

None

| Transaction Type (a) | Date (Mo., Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | |
|-----------------------------------|----------------------|---------------------------|------------------|--------------------|-----------------------|--------------------------|----------------------------|-------------------------------|----------------------------------|------------------------------------|---------------------------------------|----------------------------|
| | | \$1,001 - 1,000 | \$1,000 - 10,000 | \$10,001 - 100,000 | \$100,001 - 1,000,000 | \$1,000,001 - 10,000,000 | \$10,000,001 - 100,000,000 | \$100,000,001 - 1,000,000,000 | \$1,000,000,001 - 10,000,000,000 | \$10,000,000,001 - 100,000,000,000 | \$100,000,000,001 - 1,000,000,000,000 | Certificate of Divestiture |
| Example: (Central Airline Coupon) | 7/1/99 | | | | | | | | | | | |
| 1 | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$250; and (2) travel-related cash reimbursements received from one source totaling more than \$250. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the names of expenses received. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

None

| Source (Name and Address) | Brief Description | Value |
|--|--|----------------|
| Example: Neil Aaga, of Ronk Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room & meals incident to national conference (7/1/99) (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

Policy Exclusions Cannot Be Used.

Reporting Individual's Name: Edward M. Avalos

SCHEDULE D

Page Number: 5

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with titles such as social, fraternal, or political entities and those solely of an honorary nature.

| Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|--|----------------------------------|----------------------|-----------------|-----------------|
| Examples: Nat'l Assn. of Book Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 6/92 7/85 | Present 1/00 |
| 1 New Mexico Department of Agriculture | State Agency | Director-Marketing | 6/80 | Present |
| 2 Eddards Construction, Inc., Las Cruces, NM | S Corporation | President | 7/87 | Present |
| 3 New Mexico State Land Office-Advisory Board | Residential Construction | Vice Chairman | 2006 | Present |
| 4 | | | | |
| 5 | | | | |
| 6 | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source. Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate.

| Source (Name and Address) | Brief Description of Duties |
|--|---|
| Examples: Doe Jones & Smith, Hometown, State Metro University (client of Doe Jones & Smith), Monroeville, State | Legal services Legal services in connection with university construction |
| 1 New Mexico Department of Agriculture | State Government Agency |
| 2 | |
| 3 | |
| 4 | |
| 5 | |
| 6 | |

Prior Editions Cannot Be Used.

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).

Bart Hamilton Chilton, Bartholamew Chilton

2. Date and place of birth.

(b)(6) *Wilmington, Delaware, USA*

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).

Spouse: Sherry Chilton (formerly, Sherry Daggett, Sherry Hayes)
Occupation: Management Executive (retired from Ernst and Young LLP)

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

Purdue University 1979-1982

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

| | | |
|------------------|---|--------------------------------|
| <i>1983</i> | <i>City of Fort Wayne, Indiana</i> | <i>Aide to the Mayor</i> |
| <i>1983-84</i> | <i>Mondale for President</i> | <i>Field Organizer</i> |
| <i>1985-86</i> | <i>U.S. Hse. of Reps. Hon. Terry Bruce</i> | <i>Legislative Assistant</i> |
| <i>1987-89</i> | <i>U.S. Hse. of Reps. Hon. Jim Jontz</i> | <i>Legislative Director</i> |
| <i>1989-94</i> | <i>U.S. Hse. of Reps. Hon. Jill Long</i> | <i>Legislative Director</i> |
| <i>1995</i> | <i>U.S. Hse. of Reps. Hon. Earl Pomeroy</i> | <i>Legislative Director</i> |
| <i>1995-1999</i> | <i>U.S. Dept. of Agriculture</i> | <i>Policy Dir. Rurol Dev.</i> |
| <i>1999-2001</i> | <i>U.S. Dept. of Agriculture</i> | <i>Deputy Chief of Staff</i> |
| <i>2001</i> | <i>Bion Environmental Technologies</i> | <i>Vice President</i> |
| <i>2001-05</i> | <i>U.S. Senate Hon. Tom Daschle</i> | <i>Sen. Policy Advisor</i> |
| <i>2005-06</i> | <i>U.S. Farm Credit Administration</i> | <i>Assistant to the Board</i> |
| <i>2006-07</i> | <i>National Farmers Union</i> | <i>Chief of Staff/VP Govt.</i> |
| <i>2006-07</i> | <i>Association of Family Farms</i> | <i>Director/Treasurer</i> |
| <i>2006-07</i> | <i>Bion Environmental Technologies</i> | <i>Board Member</i> |
| <i>2007-09</i> | <i>Commodity Futures Trading Commission</i> | <i>Commissioner</i> |

6. **Military Service:** Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, serial number and type of discharge received.

No.

7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service grade levels and whether such positions were elected or appointed.

| | | |
|-----------|--------------------------------------|----------------------|
| 1985-86 | U.S. Hse. of Reps. Hon. Terry Bruce | Salaried Employee |
| 1987-89 | U.S. Hse. of Reps. Hon. Jim Jontz | Salaried Employee |
| 1989-94 | U.S. Hse. of Reps. Hon. Jill Long | Salaried Employee |
| 1995 | U.S. Hse. of Reps. Hon. Earl Pomeroy | Salaried Employee |
| 1995-1999 | U.S. Dept. of Agriculture | Schedule C (GS-15) |
| 1999-2001 | U.S. Dept. of Agriculture | Senior Exec. Service |
| 2001-05 | U.S. Senate Hon. Tom Daschle | Salaried Employee |
| 2005-06 | U.S. Farm Credit Administration | Schedule C |
| 2007-09 | Commodity Futures Trading Commission | Commissioner |

8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None.

9. **Political Affiliation:** The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Democrat.

10. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

Board Member for the following:

- Columbia Beach Citizens Improvement Association (volunteer position)*
- Association of Family Farms (volunteer position)*

11. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum

extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

All of the speeches, remarks and statements may be found at cftc.gov

September 21, 2009 Statement of Commissioner Bart Chilton Regarding the CFTC Investigation of Silver Markets, Commodity Futures Trading Commission

September 15, 2009 Speech of Commissioner Bart Chilton, "Moment of Inertia", Institutional Investors Carbon Forum

September 4, 2009 Statement of Commissioner Bart Chilton on CFTC's New Transparency Initiatives, Commodity Futures Trading Commission

September 2, 2009 Statement of Commissioner Bart Chilton, Joint Meetings on Harmonization of Regulation

August 11, 2009 Statement by Commissioner Bart Chilton, "The Right Road to Reform", Commodity Futures Trading Commission

August 4, 2009 Speech of Commissioner Bart Chilton, "Sense of Balance", American Public Gas Association Annual Meeting

July 28, 2009, Statement by Commissioner Bart Chilton, Commodity Futures Trading Commission

July 7, 2009 Statement of CFTC Commissioner Bart Chilton on Speculative Limit Hearings and Increased Transparency, CFTC

June 24, 2009 Speech of Commissioner Bart Chilton, "Picture Puzzles", Third Annual International Commodity Markets, Manipulation Enforcement Conference

June 18, 2009 Statement of Commissioner Bart Chilton on the Administration's Plan for Financial Regulatory Reform, CFTC

June 11, 2009 Speech of CFTC Commissioner Bart Chilton, "Green CAT" Markets: You Gotta Show Some Guts, Chicago Climate Exchange & Chicago Climate Futures Exchange, Sixth Annual Meeting May 20, 2009, Statement of Commissioner Bart Chilton Regarding CFTC Commissioners, Commodity Futures Trading Commission

May 13, 2009, Statement of Commissioner Bart Chilton on Regulatory Reforms for OTC Markets, Commodity Futures Trading Commission

April 29, 2009, Remarks of Commissioner Bart Chilton to the New York Regional Office: "The Luckier We Get", Commodity Futures Trading Commission

March 20, 2009, Remarks of Commissioner Bart Chilton to the American Bar Association: "Ponzimonium", Commodity Futures Trading Commission

February 10, 2009, Remarks by Commissioner Bart Chilton: "The Commodity Coaster", Washington Agricultural Roundtable, Brookings Institution

February 4, 2009, Statement of Commissioner Bart Chilton Regarding House Agriculture Committee Futures Industry Oversight Hearings and Consideration of Legislation to Improve Regulation of Futures and Derivatives Markets, Commodity Futures Trading Commission

January 28, 2009, Speech by Commissioner Bart Chilton: "Years That Answer", International Quality Productivity Center, 3rd Carbon Trading Conference

December 18, 2008, Statement of Commissioner Bart Chilton Regarding the Nomination of Gary Gensler, Commodity Futures Trading Commission

December 12, 2008, Remarks of Commissioner Bart Chilton: "Driving on Ice", European Union Agriculture and Financial Market Attachés, French Embassy

November 19, 2008, Speech by Commissioner Bart Chilton: "Banquet of Consequences", Environmental Markets Association 12th Annual Fall Conference

November 14, 2008, Statement of Commissioner Bart Chilton Regarding Central Counterparties for Credit Default Swaps, Commodity Futures Trading Commission

November 11, 2008, Statement of Commissioner Bart Chilton, Commodity Futures Trading Commission

October 28, 2008, Statement of Commissioner Bart Chilton Regarding CFTC/SEC Merger, Commodity Futures Trading Commission

October 8, 2008, Statement of Commissioner Bart Chilton on Regulation of Credit Default Swaps, Commodity Futures Trading Commission

September 17, 2008, Opening Remarks by Commodity Futures Trading Commission Commissioner Bart Chilton, CFTC Cooperative Enforcement Conference

August 14, 2008, Remarks of Commissioner Bart Chilton: "A Photographer's Eye", Michigan Agri-Business Association

July 29, 2008, Opening Statement of Commissioner Bart Chilton: "Our Progressive Discovery", Agricultural Advisory Committee, Commodity Futures Trading Commission

July 15, 2008, Statement of Commissioner Bart Chilton Regarding Global Markets Advisory Committee, Commodity Futures Trading Commission

June 25, 2008, Speech by Commissioner Bart Chilton: "The Most Important Thing", Finance IQ, Second Carbon Trading Conference

June 13, 2008, Statement of Commissioner Bart Chilton on the Increasing Transparency and Accountability in Oil Markets Act, Commodity Futures Trading Commission

June 10, 2008, Remarks of Commissioner Bart Chilton, Energy Markets Advisory Committee, Commodity Futures Trading Commission

April 29, 2008, Speech by Commissioner Bart Chilton: "Wicked Awesome" Financial Regulation, National Futures Association

April 22, 2008, Statement of Commissioner Bart Chilton: "Heartburn in the Heartland", Agricultural Markets Roundtable, Commodity Futures Trading Commission

April 21, 2008, Speech by Commissioner Bart Chilton: "The Ancient Art of Glassmaking", Future and Options Association, London, England

April 16, 2008, Statement by Commissioner Bart Chilton Regarding the President's Remarks on Climate Change, Commodity Futures Trading Commission

April 15, 2008, Remarks by Commissioner Bart Chilton: "We Can Do Better", Commodity Futures Trading Commission

April 10, 2008, Remarks by Commissioner Bart Chilton: "It's Not Easy Being Green ... Markets in the US", Carbon Roundtable

March 30, 2008, Statement of Commissioner Bart Chilton on Treasury Blueprint, Commodity Futures Trading Commission

March 28, 2008, Statement of Commissioner Bart Chilton regarding Secretary Paulson's Treasury Department Blueprint on Regulatory Reform, Commodity Futures Trading Commission

March 17, 2008, Statement of Commissioner Bart Chilton Regarding NYMEX Emissions Trading, Commodity Futures Trading Commission

March 11, 2008, Statement of Commissioner Bart Chilton Regarding CFTC-SEC Cooperation, U.S. Securities and Exchange Commission

February 27, 2008, Remarks by Commissioner Bart Chilton: "Properties of Bamboo", Futures Industry Association of Asia, Hong Kong

February 8, 2008, Speech by Commissioner Bart Chilton: CFTC's 'American Idols': Reality Regulation, Commodity Markets Council

December 6, 2007, Remarks by Commissioner Bart Chilton: "A Time for Every Purpose", Agricultural Advisory Committee Meeting, Commodity Futures Trading Commission

November 29, 2007, Remarks by Commissioner Bart Chilton: "A Better Understanding: Current Issues with SEC: Exempt Commercial Market Regulation", Futures Industry Association Expo Conference, Washington Regulators' Panel

November 13, 2007, Speech by Commissioner Bart Chilton: "Let's Not 'Dial M for Merger': CFTC's Principles-Based Regulation – A Success Story", Futures Industry Association, Law and Compliance Luncheon

November 6, 2007, Speech by Commissioner Bart Chilton: "CFTC and Energy Markets: The Cop on the Beat – Protecting Consumers", American Public Gas Association

October 16, 2007, Speech by Commissioner Bart Chilton: "Not Your Father's Regulator", Futures Industry Association, Law and Compliance Luncheon

September 18, 2007, Remarks by Commissioner Bart Chilton: "Dark Markets," Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets, Commodity Futures Trading Commission

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes.

2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None.

3. Have you ever received a government guaranteed student loan? If so, has it been repaid?

Yes. It has been paid in full.

4. If confirmed, do you have any plans, commitments, or agreements to pursue outside employment or engage in any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No.

5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No.

6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No.

7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.

None.

8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above

items. In particular, identify all investments, obligations, liabilities, or other relationships which involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

There are no such conflicts or potential conflicts. Should such a conflict or potential conflict arise, I will consult with the designated agency ethics officer and take any steps necessary to resolve it.

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.

None.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

May 26, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Bart H. Chilton, who has been nominated by President Obama for the position of Commissioner, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures



U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581
www.cftc.gov

Bart Chilton
Commissioner

(202) 418-5060
(202) 418-5620 Facsimile
bchilton@cftc.gov

April 1, 2009

Mr. John P. Dolan
Counsel and Alternate Designated Ethics Official
Office of the General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

This letter describes the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Commissioner for the Commodity Futures Trading Commission ("CFTC").

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver pursuant to section 208(b)(1) or qualify for a regulatory exemption pursuant to section 208(b)(2). I understand that the interests of the following persons are imputed to me: my spouse and minor children; any general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

John Dolan
Page 2

Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,

A handwritten signature in black ink, appearing to be 'Bart H. Chilton', written over a horizontal line.

Bart H. Chilton

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | | | | | |
|---|---|---|---------------------------------|--|--|---|---|---|
| Date of Appointment, Candidacy, Election, or Nomination (Month, Day, Year) | Reporting Status (Check Appropriate Boxes) | Incumbent <input type="checkbox"/> | Calendar Year Covered by Report | New Entrant, Nominee, or Candidate <input checked="" type="checkbox"/> | Termination Filer <input type="checkbox"/> | Termination Date (If Applicable) (Month, Day, Year) | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period, shall be subject to a \$200 fee. | |
| Reporting Individual's Name | Last Name Chilton | First Name and Middle Initial Bart H | | | | | | |
| Position for Which Filing | Title of Position Commissioner | Department or Agency (If Applicable) Commodity Futures Trading Commission | | | | | | Reporting Periods Incumbents: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. |
| Location of Present Office (or forwarding address) | Address (Number, Street, City, State, and ZIP Code) Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581 | Telephone No. (Include Area Code) 202.418.5080 | | | | | | |
| Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | Title of Position(s) and Date(s) Held Commissioner, CFTC August 14, 2007 to Present | | | | | | | Termination Filer: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Presidential Nominations Subject to Senate Confirmation | Name of Congressional Committee Considering Nomination Committee on Agriculture, Nutrition and Forestry | Do You Intend to Create a Qualified Diversified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | | | | | |
| Certification | Signature of Reporting Individual | Date (Month, Day, Year) | | | | | | Nominees, New Entrants and Candidates for President and Vice President: Schedule A—The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. Schedule B—Not applicable. Schedule C, Part I (Liabilities)—The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. Schedule C, Part II (Agreements or Arrangements)—Show any agreements or arrangements as of the date of filing. Schedule D—The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| Other Review (If Desired by Agency) | Signature of Reviewer | Date (Month, Day, Year) | | | | | | |
| Agency Ethics Official's Opinion | Signature of Designated Agency Ethics Official/Reviewing Official | Date (Month, Day, Year) | | | | | | |
| Office of Government Ethics Use Only | Signature | Date (Month, Day, Year) | | | | | | |
| Comments of Reviewing Officials (If additional space is required, use the reverse side of this sheet) | | | | | | | | |
| (Check box if filing extension granted & indicate number of days) <input type="checkbox"/> | | | | | | | | |
| (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | | | | | | | |
| Agency Use Only | | | | | | | | |
| OGE Use Only | | | | | | | | |
| MAY 20 2009 | | | | | | | | |

99 of 308

93

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | | Page Number | | | | | | | | |
|------------------------------|---|----------------------|--|--|--|--|--|--|--|--|---|--|----------|-------------|---------------------------|--|---|--------------------------|----------------------------|----------------|--|---------------|
| Chilton, Carl H. | | (Use only if needed) | | | | | | | | | | | | 2 of 6 | | | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: Type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | | |
| | | | | | | | | | | | BLOCK C | | | | | | | | | | | |
| | | | | | | | | | | | | | Type | Amount | | | | | | | | |
| | | | | | | | | | | | | | Dividend | Interest | None (or less than \$201) | Over \$1,000 - \$14,999 | Over \$15,000 - \$49,999 | Over \$50,000 - \$99,999 | Over \$100,000 - \$499,999 | Over \$500,000 | | |
| 1 | IWN-ISHARES TR Russell 2000 Value | X | | | | | | | | | | | | | | | | | | | | |
| 2 | IWO-ISHARES TR Russell 2000 Growth | X | | | | | | | | | | | | | | | | | | | | |
| 3 | SBSPX Legg Mason Partners S&P 500 | X | | | | | | | | | | | | | | | | | | | | |
| 4 | Smith Barney "XCABX" Scholars Choice Equity 80% 529 Plan CUSIP # 80705P294000 | X | | | | | | | | | | | | | | | | | | | | |
| 5 | Drayfus Money Market CUSIP # 262016108000 | X | | | | | | | | | | | | | | | | | | | | |
| 6 | Ernst & Young, LLP | | | | | | | | | | | | | | | | | | | | | Spouse Salary |
| 7 | Ernst & Young, LLP -401(K) --Fidelity Magellan Class K (FMGKX) | | | | | | | | | | | | | | | | | | | | | |
| 8 | Ernst & Young, LLP -401(K) --Fidelity Low Price (MCV) | | | | | | | | | | | | | | | | | | | | | |
| 9 | ALEX RVS Large Cap Large Cap Equity Fund Class A | X | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.
 - Prior Editions Cannot be Used

95

101 of 308

Reporting Individual's Name

Chilton, Bert H.

SCHEDULE A continued

(Use only if needed)

Page Number

3 of 6

| BLOCK A | Valuation of Assets at close of reporting period | | | | | | | | BLOCK B | | BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | | | |
|---|--|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|------------------|------------------|-------------------|---------|--------|--------------------|--------------------|-----------|----------|---------------------------|-------------------|-------------------|--------------------|---|--|---------------------|----------------------|----------------|------------------|------------------|--|
| | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Type | Amount | | | | | | | | | | | | | | | | |
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$50,000,000 | | | Over \$100,000,000 | Over \$500,000,000 | Dividends | Interest | None (or less than \$201) | \$1,001 - \$1,500 | \$1,501 - \$5,000 | \$5,001 - \$15,000 | | | \$15,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$1,000,000 | Over \$5,000,000 | |
| 1 Ernst & Young, LLP -- 401(K) -- Fidelity Balance | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 Ernst & Young, LLP -- 401(K) -- Dodge & Cox Stock (DODGX) | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 Ernst & Young, LLP -- 401(K) -- American Funds Europac Growth R5 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 Ernst & Young, LLP -- 401(K) -- Managers Fremont Bond | x | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Vanguard Target RET 2015 Inv. CL (VTXX) | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.

Printed Document

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: **Chilton, Bart H.** Page Number: **4 of 6**

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| | Identification of Assets | Transaction Type (x) | Date (Mo., Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | | | |
|---|----------------------------------|----------------------|----------------------|---------------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|---------------------------|---------------------------|----------------------------|-------------------|-------------------|----------------------------|--|
| | | | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$2,500,000 | \$2,500,001 - \$5,000,000 | \$5,000,001 - \$10,000,000 | Over \$10,000,000 | Over \$50,000,000 | Certificate of Divestiture | |
| 1 | Example: Central Airlines Common | x | 2/1/99 | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Source (Name and Address) | Brief Description | Value |
|--|--|----------------|
| Examples: Nat'l Assn. of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room, & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

Prior Filings Cannot Be Used.

103 of 308

| | | |
|--|-------------------|------------------------------|
| Reporting Individual's Name Chilton, Bart H. | SCHEDULE C | Page Number 5 of 6 |
|--|-------------------|------------------------------|

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out; loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None

Category of Amount or Value (\$)

| Date Incurred | Interest Rate | Term if applicable | Category of Amount or Value (\$) | | | | | | | | | | | | | | | | | | | |
|---------------|---------------|--------------------|----------------------------------|--------------------|--------------------|---------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------|--|--|--|--|--|--|--|--|--|--|
| | | | Over \$10,000 to \$25,000 | 25,000 to \$50,000 | 50,000 to \$75,000 | 75,000 to \$100,000 | 100,000 to \$125,000 | 125,000 to \$150,000 | 150,000 to \$200,000 | 200,000 to \$250,000 | 250,000 to \$500,000 | Over \$500,000 | | | | | | | | | | |
| Examples: | | | | | | | | | | | | | | | | | | | | | | |
| | 1991 | 8% | 25 yrs. | | | | | | | | | | | | | | | | | | | |
| | 1999 | 10% | on demand | | | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g. 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits

None

| Example | Status and Terms of any Agreement or Arrangement | Parties | Date |
|---------|--|---------|------|
| | | | |
| 2 | | | |
| 3 | | | |
| 4 | | | |
| 5 | | | |
| 6 | | | |

Prior Editions Cannot Be Used.

| | | |
|---|-------------------|-----------------------|
| Reporting Individual's Name Chilton, Bart H. | SCHEDULE D | Page Number 6 of 6 |
|---|-------------------|-----------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|--|------------------------------|------------------|-----------------|---------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6/92 | Present |
| | Doc Jones & Smith, Hometown, State | Law firm | Partner | 7/85 | 1/06 |
| 1 | Farmers Educational & Cooperative Union of America | Non-Profit Trade Association | Chief of Staff | 06/2008 | 08/2007 |
| 2 | Association of Family Farms | 510(c)(3) | Director/Officer | 10/2006 | 08/2007 |
| 3 | Bion Environmental Technologies | For Profit Company | Director | 10/2006 | 08/2007 |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate
 None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|--|---|
| Examples: | Doc Jones & Smith, Hometown, State | Legal services |
| | Metro University (client of Doc Jones & Smith), Moesytown, State | Legal services in connection with university construction |
| 1 | Farmers Educational & Cooperative Union of America | Chief of Staff |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Print Editions Cannot Be Used.

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).
Scott Douglas O'Malia
2. Date and place of birth.
(b)(6) **South Bend, IN**
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).
Married
Marissa Reyes O'Malia, formerly Marissa Jane Reyes
Doctor of Chiropractic
Dr. Marissa R. O'Malia, P.C.
2440 M Street, NW #807, Washington, D.C. 20037
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.
9/85-12/86 Lansing Community College, Kyoto Education Center Japan
1/87-5/90 University of Michigan, Ann Arbor, BA LSA 5/4/90
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

Public Securities Association -- 1990-1991
Assistant Political Manager
Managed PSA PAC activities that included fundraising, correspondence, Federal Election Commission filing, and special events. Drafted weekly updates on political events for industry newsletter.

Senator McConnell -- 1991-2001
Legislative Staff
Responsible for appropriations as well as energy, environment, education, tax policy, and commercial policy issues.

Mirant -- 2001 - 2003
Director
Developed a policy organization within Mirant and financial trade associations to bring together commercial interests, investor relations and legal staff to review federal legislative initiatives and develop the appropriate policy response. Also worked with international business units regarding merger activity and terrorism insurance.

U.S. Senate Energy Committee -- 2003-2004**Professional Staff**

Developed policies related to oil and natural gas markets including conducting congressional hearings and drafting legislative initiatives.

Energy and Water Development Subcommittee, Committee on Appropriations -- 2004-Present**Clerk**

Responsibilities include drafting and passage of the Energy and Water Development appropriation legislation providing funding to the Department of Energy (\$26 billion budget), U.S. Army Corps of Engineers (\$ 5.3 billion budget), and Bureau of Reclamation (\$1 billion budget).

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.
No Military Service
7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.
U.S. Senator McConnell
U.S. Senate Committee on Energy and Natural Resources
U.S. Senate Committee on Appropriations
8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.
Worker Health Protection Program Award 2006 -- For assistance to Department of Energy Defense Nuclear Workers
9. Political Affiliation: The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.
Republican
10. Other Memberships: If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.
Key School PTA, Arlington VA
Gunston Middle School PTA, Arlington, VA
Stennis Fellows, Washington, D.C.
11. Published Writings: List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please

include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

N/A

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?
Yes
2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.
**Mirant warrants provided on 1/3/06. Qty: 119 Warrants - \$1768 value,
Mirant stock Qty: 37 shares - \$661 value
Attachment: Conflict of Interest letter**
3. Have you ever received a government guaranteed student loan? If so, has it been repaid?
No
4. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)
No
5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)
No
6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)
No
7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.
No
8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.
Attachment: Conflict of Interest Letter

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.
Attachment: Conflict of Interest Letter



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

September 18, 2009

The Honorable Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Scott D. O'Malia, who has been nominated by President Obama for the position of Commissioner, Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosures

August 31, 2009

Mr. John P. Dolan
Counsel and Alternate Designated
Agency Ethics Official
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Dolan:

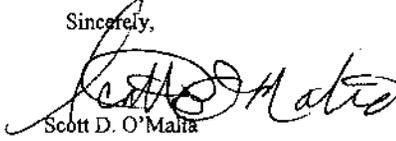
In regard to your review of my public financial disclosure report ("SF 278") and in anticipation of my nomination by President Obama, I wish to advise you of the steps I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed as Commissioner of the Commodity Futures Trading Commission.

As required by 18 U.S.C. 208 (a), I will not participate personally or substantially in any particular matter that has a direct and predictable effect on my financial interest or those of any person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. 208 (b)(1), or qualify for a regulatory exemption pursuant to 18 U.S.C. 208 (b)(2). I understand that the interests of the following person are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

I own warrants for shares of Mirant Corporation common stock. Within 90 days of confirmation, I will divest my warrants in the Mirant Corporation because ownership of this security is a prohibited interest pursuant to CFTC's Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission at 17 C.F.R. § 140.735-2a(b)(2). If I divest the warrants by exercising them, I will also divest the resulting stock within 90 days of my confirmation. Until this divestiture has been completed, I will not participate personally and substantially in any particular matter that will have a direct and predictable effect on the financial interests of Mirant Corporation.

Finally I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to commitments I have made in this and any other ethics agreement.

Sincerely,



Scott D. O'Malia

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| | | | | |
|---|---|---|--|--|
| Date of Appointment, Candidacy, Election or Nomination (Month, Day, Year) | Reporting Status (Check appropriate boxes) <input type="checkbox"/> Incumbent <input type="checkbox"/> New Entrant, Nominee, or Candidate <input checked="" type="checkbox"/> Termination [Termination Date (if applicable) (Month, Day, Year)] | Calendar Year Covered by Report | <input type="checkbox"/> Incumbent <input checked="" type="checkbox"/> New Entrant, Nominee, or Candidate <input type="checkbox"/> Termination [Termination Date (if applicable) (Month, Day, Year)] | Fee for Late Filing Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting individual's Name | Last Name O'Malia | First Name and Middle Initial Scott D. | Reporting Periods Instructions: The reporting period is the preceding calendar year except Part II of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. | |
| Position for Which Filing | Title of Position Commissioner | Department or Agency (if applicable) Commodity Futures Trading Commission (CFTC) | Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. | |
| Location of Present Office (or forwarding address) | Address (Number, Street, City, State, and ZIP Code) 188 Dirksen Senate Office Building, U.S. Senate Washington, D.C. | Telephone No. (Include Area Code) 202-224-2039 | Nominees, New Entrants and Candidates for President and Vice President: Schedule A: The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. Schedule B: Not applicable. Schedule C: Part II (Institutional Arrangements): The reporting period is the preceding calendar year and the current calendar year up to any date you choose that is within 31 days of the date of filing. Schedule D: Part II (Arrangements): Show any agreements or arrangements as of the date of filing. | |
| Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | Title of Position(s) and Date(s) Held Clerk, Senate Appropriations Committee, Subcommittee on Energy and Water Development 2004-Present | | | |
| Presidential Nominee Subject to Senate Confirmation | Name of Congressional Committee Considering Nomination Senate Agriculture Committee | Do You Intend to Create a Qualified Diversified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | |
| Certification | Signature of Reporting Individual | Date (Month, Day, Year) | | |
| I CERTIFY that the statements I have made on this form and all attached schedules are true, complete and correct to the best of my knowledge. | <i>Scott D. O'Malia</i> | 8/12/09 | | |
| Other Review (if desired by agency) | Signature of Other Reviewer | Date (Month, Day, Year) | | |
| | <i>John P. Doherty</i> | 09-11-09 | | |
| Agency Ethics Official's Opinion | Signature of Designated Agency Ethics Official/Supervising Official | Date (Month, Day, Year) | | |
| On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below). | <i>William H. Bledsoe</i> | 9-11-09 | | |
| Office of Government Ethics Use Only | Signature | Date (Month, Day, Year) | | |
| | <i>Theresa J. Cramer</i> | 9/15/09 | | |
| Comments of Reviewers/Officials (If additional space is required, use the reverse side of this sheet) | | | | |
| | | | | |

108

114 OF 308

Reporting Individual's Name
 Scott D. O'Malia

SCHEDULE A

Page Number
 2

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day, Yr.) Only if Honoraria | | | | |
|--|---|---------------|---------------------|-------------------------|---------------------------|----------------------------|-------------------|---------------------------|-----------------|-------------------|--|---------------------|----------------------|----------------|------------------|------------------|---|--|--|--|---|--|--|--|--|
| | | | | | | | | | | | Amount | | | | | | | | | | | | | | |
| | None | Under \$1,000 | \$1,000 - \$100,000 | \$100,000 - \$1,000,000 | \$1,000,000 - \$5,000,000 | \$5,000,000 - \$10,000,000 | Over \$10,000,000 | None (or less than \$201) | \$201 - \$1,000 | \$1,000 - \$5,000 | \$5,000 - \$10,000 | \$10,000 - \$50,000 | \$50,000 - \$100,000 | Over \$100,000 | Over \$1,000,000 | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | | | | | | | | |
| Examples | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 Columbia Cash Reserves (Money Market Fund) NXKXX OTC | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 American Century Fund Mutual Fund TXCVX | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 Columbia Small Cap Values Mutual Fund CSCZX | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 Dodge and Cox Stock Mutual Fund DODGX | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Madison Mosaic Mid Cap Mutual Fund GTSGX | x | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 T. Rowe Price Summit Mutual Mutual Fund PRSMX | x | | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.

Prior Editions Cannot be Used

Reporting Individual's Name: **Scott D. O'Malia** Page Number: **3**

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day, Yr.) Only if Honorary | | | | | | |
|---|---|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|---|----------|----------|--------------|-----------------|-------------------|--------------------|---------------------|----------------------|-----------------------|---|--|-----------------------|----------------|--|--|--|
| | None (or less than \$201) | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | None (or less than \$201) | Dividend | Interest | Capital Gain | Amount | | | | | | | Other Income (Specify Type & Actual Amount) | | | | | |
| | | | | | | | | | | | | \$201 - \$1,000 | \$1,001 - \$5,000 | \$5,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | | | \$250,001 - \$500,000 | Over \$500,000 | | | |
| 1 Eaton Vance Large Cap Value Mutual Fund EHSX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 2 Goldman Sachs Mid Cap Value Mutual Fund GCMAX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 3 Thornburg International Value Mutual Fund TGVIX | | | X | | | | | | | | | | | | | | | | | | | | | |
| 4 Columbia Cash Reserve Mutual Fund NCRXX | X | | | | | | | | | | | | | | | | | | | | | | | |
| 5 Target Focus Four Unit Investment Trust FTCROX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 6 Target Focus Four Unit Investment Trust FOCFNX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 7 Target Focus Four Unit Investment Trust FCUWZX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 8 Pimco Total Return Institutional Mutual Fund PTRX | | X | | | | | | | | | | | | | | | | | | | | | | |
| 9 Columbia Marsico 21st Century Mutual Fund NMYAX | X | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | | | | | | | | |
|-------------------------------|--|----------------------|--|---|--|--|---|---|---|--|--|-------------|----------------|--|---|-------------------|-------------------|--------------------------------|---------------|--|--|--|--|
| Scott D. O'Malia | | (Use only if needed) | | | | | | | | | | 8 | | | | | | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | | | | | |
| | BLOCK B | | | | | | BLOCK C | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | Type | Amount | | | | | | | | | |
| | | | | | | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$1,500 | \$1,501 - \$5,000 | \$5,001 - \$10,000 | Over \$10,000 | | | | |
| | | | | | | | | | | | | | Excepted Trust | | | | | | | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | Janus Research Fund Mutual Fund JAMRX | | | | | | | | | | | | | | | | | | | | | | |
| 2 | Schares Russell 2000 Value Index Fund IWRN | X | | | | | | | | | | | | | | | | | | | | | |
| 3 | M&T Bank Checking/Savings | | | | | | | X | X | | | | | | | | | | | | | | |
| 4 | Seneca Federal Credit Union Checking/Savings | | | | | | | X | X | | | | | | | | | | | | | | |
| 5 | Wachovia Crown Banking-Checking | X | | | | | | X | X | | | | | | | | | | | | | | |
| 6 | Bank of America Certificate of Deposit | | | X | | | | X | X | | | | | | | | | | | | | | |
| 7 | Income (Spouse) Med Practice Washington, D.C. S-Corp W2 | | | | | | | | | | | | | | | | | Business Income | | | | | |
| 8 | SCORP Equity (Spous) Medical Practice, Wash, D.C. Marissa R. O'Malia, PC | | | | | | | | | | | | | | | | | Business Income | | | | | |
| 9 | IX Inc. Toronto Canada Comp Software, LLC | | | | | | | | | | | | | | | | | Business Income \$20,000.00 | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name
 Scott D O'Malia

SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | |
|-------------------------------|---|---------------------|------------------------|--------------------------|----------------------------|-----------------------------|------------------------------|------------------------------|-------------------------------|--------------------------------|--|--------------------|----------------------------------|--------------------------------|----------------------------------|--------------------|---|--|--|--|
| | None <input type="checkbox"/> | Over \$15 - 100,000 | Over 100,000 - 500,000 | Over 500,000 - 1,000,000 | Over 1,000,000 - 5,000,000 | Over 5,000,000 - 10,000,000 | Over 10,000,000 - 25,000,000 | Over 25,000,000 - 50,000,000 | Over 50,000,000 - 100,000,000 | Over 100,000,000 - 500,000,000 | Over 500,000,000 - 1,000,000,000 | Over 1,000,000,000 | Over 1,000,000,000 - 100,000,000 | Over 100,000,000 - 500,000,000 | Over 500,000,000 - 1,000,000,000 | Over 1,000,000,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | |
| Type | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | |
| 1 Potts | X | | | | | | | | | | | | | | | | | | | |
| 2 GATX Corp GMT: NYSE | X | | | | | | | | | | | | | | | | | | | |
| 3 General Electric | X | | | | | | | | | | | | | | | | | | | |
| 4 Glaxo Sciences, Inc | X | | | | | | | | | | | | | | | | | | | |
| 5 GlaxoSmithKline, PLC | X | | | | | | | | | | | | | | | | | | | |
| 6 Google, Inc | X | | | | | | | | | | | | | | | | | | | |
| 7 Harbor International | X | | | | | | | | | | | | | | | | | | | |
| 8 Hartford Financial Services | X | | | | | | | | | | | | | | | | | | | |
| 9 HBOS PLC | X | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 Prior Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued (Use only if needed) | | | | | | | | | | Page Number | | | | | |
|-------------------------------|---|--|--|--|--|--|--|--|--|--|---|-------------|---|--------------------------------------|--|--|--|
| Scott D. O'Malia | | | | | | | | | | | | 15 | | | | | |
| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None or less than \$201" is checked, no other entry is needed in Block C for that item. | | Date (Mo., Day, Yr.) Only if Honoraria | | | | |
| | | | | | | | | | | | Type | Amount | | Other Income (Specify Type & Amount) | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | |
| 1 | HEICO Corp | X | | | | | | | | | | | | | | | |
| 2 | Hewlett-Packard, Co | X | | | | | | | | | | | | | | | |
| 3 | Honeywell International | X | | | | | | | | | | | | | | | |
| 4 | Index Corp INDQY: Pink Sheets | X | | | | | | | | | | | | | | | |
| 5 | Indext Labs Corp IDXX: Nasdaq | X | | | | | | | | | | | | | | | |
| 6 | HIS Inc | X | | | | | | | | | | | | | | | |
| 7 | ING Group | X | | | | | | | | | | | | | | | |
| 8 | Intel Corp | X | | | | | | | | | | | | | | | |
| 9 | International Business Machines | X | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher category.
 Prior Editions Cannot be Used

Reporting Individual's Name
 Scott D O'Malia

SCHEDULE A continued

Page Number
 16

(Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None for less than \$2011" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|-------------------------------|---|--|--|--|--|--|--|--|--|--|---|--------|--|--|--|--|--|--|--|--|--|---|
| | BLOCK C | | | | | | | | | | Type | Amount | | | | | | | | | | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | |
| 1 Intersil Corp | X | | | | | | | | | | | | | | | | | | | | | |
| 2 ITC Holding Corp | X | | | | | | | | | | | | | | | | | | | | | |
| 3 JPMorgan Chase & Co | X | | | | | | | | | | | | | | | | | | | | | |
| 4 JSC MMC Norikah Nickel | X | | | | | | | | | | | | | | | | | | | | | |
| 5 Kookmin BK KB: NYSE | X | | | | | | | | | | | | | | | | | | | | | |
| 6 Kroger Co | X | | | | | | | | | | | | | | | | | | | | | |
| 7 Laboratory Corp. | X | | | | | | | | | | | | | | | | | | | | | |
| 8 Lincare Holdings | X | | | | | | | | | | | | | | | | | | | | | |
| 9 Lufkin Inds Inc. | X | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 Prior Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | | |
|------------------------------|---|----------------------|--|--|--|--|--|--|--|-------------------------------|---|-------------|--|---|--|--|--|
| Scott D. O'Malia | | (Use only if needed) | | | | | | | | | | 17 | | | | | |
| Assets and Income BLOCK A | Valuation of Assets as close of reporting period BLOCK B | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | |
| | | | | | | | | | | | Type | Amount | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | |
| | | | | | | | | | | None <input type="checkbox"/> | None (or less than \$201) | | | | | | |
| 1 MEMC Electronics Materials | X | | | | | | | | | | | | | | | | |
| 2 MFS Value | | X | | | | | | | | | | | | | | | |
| 3 Macys Inc | | X | | | | | | | | | | | | | | | |
| 4 Mairkel Corp Holdings Co | | X | | | | | | | | | | | | | | | |
| 5 McDonalds Corp | | X | | | | | | | | | | | | | | | |
| 6 McKesson Corp | | X | | | | | | | | | | | | | | | |
| 7 Merck & Co Inc | | X | | | | | | | | | | | | | | | |
| 8 Meridian Bioscience Inc | | X | | | | | | | | | | | | | | | |
| 9 Mettler Inc | | X | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 Prior Editions Cannot be Used.

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | | Page Number | | | | | | |
|-----------------------------|-----------------------------------|--|---|--|---------------------------|------------------|--------------------|--------------------|--------------------|------------------------|------------------------|--------------------------|--------------------------|---|--|---|--|--|--|--|
| Scott D. O'Malia | | (Use only if needed) | | | | | | | | | | | | 19 | | | | | | |
| BLOCK A | BLOCK B | BLOCK C | | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | | | |
| | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | | | | | | | |
| Assets and Income | | Valuation of Assets at close of reporting period | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | |
| | | | | Type | Amount | | | | | | | | | | | | | | | |
| | | | | None <input type="checkbox"/> | None (or less than \$201) | Over \$25 - \$99 | Over \$100 - \$249 | Over \$250 - \$499 | Over \$500 - \$999 | Over \$1,000 - \$4,999 | Over \$5,000 - \$9,999 | Over \$10,000 - \$49,999 | Over \$50,000 - \$99,999 | Over \$100,000 - \$499,999 | Over \$500,000 - \$999,999 | Over \$1,000,000 | | | | |
| 1 | Norsk Hydro Nasdaq: Euronext | X | | | | | | | | | | | | | | | | | | |
| 2 | Northrup Grumman Corp Holdings Co | X | | | | | | | | | | | | | | | | | | |
| 3 | Ntelos Holdings | X | | | | | | | | | | | | | | | | | | |
| 4 | Nuveen Flagship Muni Bonds | | X | | | | | | | | | | | | | | | | | |
| 5 | Lukoil Oil | X | | | | | | | | | | | | | | | | | | |
| 6 | Oracle Corporation | X | | | | | | | | | | | | | | | | | | |
| 7 | Onix Corp | X | | | | | | | | | | | | | | | | | | |
| 8 | Owens Illinois Inc OTC: NYSE | X | | | | | | | | | | | | | | | | | | |
| 9 | Pactiv Corp | X | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category.
 Prior Editions Cannot be Used

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Scott D. O'Maha Page Number 28

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| Identification of Asset | Transaction Type (s) | | | Date (mo., Day, Yr.) | Amount of Transaction (s) | | | | | | | | | | |
|------------------------------------|----------------------|------|----------|----------------------|---------------------------|------------------------|----------------------------|-------------------------------|--------------------------------|---------------------------------|----------------------------------|------------------------------------|----------------------|-------------------|--------------------|
| | Purchase | Sale | Exchange | | \$1,001 - \$1,000 | \$1,001.01 - \$100,000 | \$100,000.01 - \$1,000,000 | \$1,000,000.01 - \$10,000,000 | \$10,000,000.01 - \$50,000,000 | \$50,000,000.01 - \$100,000,000 | \$100,000,000.01 - \$500,000,000 | \$500,000,000.01 - \$1,000,000,000 | Over \$1,000,000,000 | Over \$50,000,000 | Over \$100,000,000 |
| Example: Central Airlines Contract | ✓ | | | 3/1/99 | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude reimbursements to you by the U.S. Government; gifts to your agency in connection with official travel; received from relatives; received by your spouse or dependent child solely independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Source (Name and Address) | Brief Description | Value |
|--|---|----------------|
| Examples: Hal Asan, of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airfare ticket, hotel room & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

For Editors' Cannot Be Used

133

139 of 308

Reporting Individual's Name
 Scott D. O'Malia

SCHEDULE C

Page Number
 28

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out, loans secured by automobiles, household furniture or appliances, and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None

Category of Account or Value (C)

| Date Incurred | Interest Rate | Term if applicable | Category of Account or Value (C) | | | | | | | | | | | | | | | | | | |
|---------------|---------------|--------------------|----------------------------------|-----------|----------|---------|--------|-------|------|-----|----|---|--|--|--|--|--|--|--|--|--|
| | | | 1000000000 | 100000000 | 10000000 | 1000000 | 100000 | 10000 | 1000 | 100 | 10 | 1 | | | | | | | | | |
| 1998 | 8% | 25 yrs | | | | | | | | | | | | | | | | | | | |
| 1999 | 10% | undated | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits

None

| Status and Terms of any Agreement or Arrangement | Parties | Date |
|--|------------------------------------|------|
| Example: Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/30/02 | Doe Jones & Smith, Hometown, State | 7/01 |
| 1. Merit Warrants (119 units) will be divested | Merit | 1/06 |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |

Precedence Cannot Be Used

135

141 of 308

| | | |
|--|-------------------|-------------------|
| Reporting Individual's Name Scott D. O'Malley | SCHEDULE D | Page Number 29 |
|--|-------------------|-------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) | | | | | | | | | | |
|---------------------------------------|--|---------------------------------------|----------------------|-----------------|---------------|---------|------------------------------------|----------|---------|------|------|--|--|--|--|
| Examples: | <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="border-bottom: 1px dashed black;">Natl Assn. of Rack Collectors, NY, NY</td> <td style="border-bottom: 1px dashed black;">Non-profit education</td> <td style="border-bottom: 1px dashed black;">President</td> <td style="border-bottom: 1px dashed black;">6/92</td> <td style="border-bottom: 1px dashed black;">Present</td> </tr> <tr> <td style="border-bottom: 1px dashed black;">Doe Jones & Smith, Hometown, State</td> <td style="border-bottom: 1px dashed black;">Law firm</td> <td style="border-bottom: 1px dashed black;">Partner</td> <td style="border-bottom: 1px dashed black;">7/85</td> <td style="border-bottom: 1px dashed black;">1/00</td> </tr> </table> | Natl Assn. of Rack Collectors, NY, NY | Non-profit education | President | 6/92 | Present | Doe Jones & Smith, Hometown, State | Law firm | Partner | 7/85 | 1/00 | | | | |
| Natl Assn. of Rack Collectors, NY, NY | Non-profit education | President | 6/92 | Present | | | | | | | | | | | |
| Doe Jones & Smith, Hometown, State | Law firm | Partner | 7/85 | 1/00 | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate.
None

| | Source (Name and Address) | Brief Description of Duties | | | | |
|---|--|------------------------------------|----------------|---|---|--|
| Examples: | <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="border-bottom: 1px dashed black;">Doe Jones & Smith, Hometown, State</td> <td style="border-bottom: 1px dashed black;">Legal services</td> </tr> <tr> <td style="border-bottom: 1px dashed black;">Metro University (Client of Doe Jones & Smith), Hometown, State</td> <td style="border-bottom: 1px dashed black;">Legal services in connection with university construction</td> </tr> </table> | Doe Jones & Smith, Hometown, State | Legal services | Metro University (Client of Doe Jones & Smith), Hometown, State | Legal services in connection with university construction | |
| Doe Jones & Smith, Hometown, State | Legal services | | | | | |
| Metro University (Client of Doe Jones & Smith), Hometown, State | Legal services in connection with university construction | | | | | |
| 1 | | | | | | |
| 2 | | | | | | |
| 3 | | | | | | |
| 4 | | | | | | |
| 5 | | | | | | |
| 6 | | | | | | |
| 7 | | | | | | |
| 8 | | | | | | |

Prior Editions Cannot Be Used

136

142 of 308

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used):

Harris Daniel Sherman

2. Date and place of birth:

(b)(6) **Denver, Colorado**

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name, and business address(es).

Divorced.

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

Colorado College, 1960-1964, B.A. (History), 1964.

Columbia University Law School, 1964-1967, LL.B, 1967

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college. Please include title and brief job description for each.

VISTA, Attorney (working with community organizations in Chicago)—1967-1968.

Chicago Public Schools, Teacher (5th Grade)—1968-1969.

Sherman, Sherman, & Morgan, Attorney (general law practice in Denver, Co.)—1969-1974.

Environmental Defense Fund, Attorney (environmental law practice in Denver, Co.)—1973-1975.

Colorado Department of Natural Resources, Executive Director (appointed by Governor Richard Lamm to oversee Colorado's energy, wildlife, water, parks, and state land programs)—1975-1980.

Arnold & Porter, Partner (specializing in natural resources, environmental, public lands, water, and American Indian law in Denver, Co.)—1980-2007.

Colorado Department of Natural Resources, Executive Director (appointed by Governor Bill Ritter to oversee Colorado's energy, wildlife, water, parks, forestry, and state lands programs)—2007-Present.

6. **Military Service:** Have you served in the military? If so, please give particulars, including the dates, branch of service, rank or rate, and type of discharge received.

No.

7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.

VISTA Attorney—1967-1968.

Colorado Department of Natural Resources, Executive Director, 1975-1980 (Appointed).

Colorado Department of Natural Resources, Executive Director, 2007-Present (Appointed).

8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

Phi Beta Kappa

Pi Gamma Mu

Woodrow Wilson Fellowship (Honorable Mention).

Honorary Doctorate of Laws, Colorado College

Thorne Ecological Institute, Environmental Award

American Bar Association, Fellow

9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

The Boettcher Foundation, Trustee, 2004- Present

Colorado College, Trustee, 1998-2005

Denver Water Board, Commissioner, 2005-2007

Colorado Forum, Member, 1986 - 2007

Trust For Public Land (National Advisory Council), 1990-2007

Trust For Public Land (Chair, Colorado Advisory Council), 1996-2007

Denver Regional Air Quality Council, Chair

Wirth Chair, University of Colorado, Trustee, 2004-2007

A & P Realty Associates, General Partnership, 1982-Present

10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include in this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you would provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry, or any other matters within the jurisdiction of this Committee or the Department of Agriculture.

See Attachment A

I do not use prepared text for my speeches, but I have included a list of my public speaking events.

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, partnerships, associations, or other organizations? (If no, provide full details.)

Yes. Please note that while I have severed all ties with my previous law firm, Arnold & Porter, I receive monthly payments from Arnold & Porter under its retirement plan. This is described in greater detail in response to Question #2

below.

2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits that you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

Arnold & Porter Retirement Plan (unfunded retirement benefits arising from the Firm's Partnership Agreement). 2009 annual anticipated receipts will be approximately \$194,000.

State of Colorado PERA (upon leaving State employment, I will receive \$350 a month).

3. Do you, or any partnership or closely held corporation or other entity in which you have an interest, own or operate a farm or ranch? (If yes, provide a brief description including location, size, and type of operation.)

Since 1981, I have owned a one-third interest in a 450 acre ranch in Summit County, Colorado. Two other families own the remaining two-thirds interest. The entire ranch is subject to a conservation easement held by the American Farmland Trust. Under the terms of the conservation easement, the property cannot be developed beyond the existing home sites. Limited grazing of horses and cattle occur through a lease with the adjacent rancher. We receive no income under the lease although we have a reciprocal arrangement whereby we can recreate on the adjacent ranchers property and he agrees to maintain our ditches and headgates. The property is not held for investment purposes.

4. Have you, or any partnership or closely held corporation or other entity in which you have an interest, ever participated in federal commodity income and price support, disaster, conservation, or related programs? (If yes, provide full details, including descriptions and amounts of payments and loans received or forfeited relating to each commodity, crop, farm, and ranch involved during the past five years.)

No.

5. Have you, or any partnership or closely held corporation or other entity in which you have an interest, received payments for crop or livestock losses from the federal crop insurance program in the past five years? (If yes, provide full details and amounts.)

No.

6. Have you ever received a student loan or loans? If so, has all indebtedness been

fully repaid? (If no, provide full details.)

No.

7. Have you, or any partnership or closely held corporation or other entity in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any department or agency of the federal government (other than a student loan), including, for example, through the farm or rural development lending programs of the Department of Agriculture or through the Small Business Administration? (If yes, provide the current status and details of such loan or loans, whether the indebtedness has been fully repaid, and all details of any such loan activity.)

No.

8. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain fully.)

No.

9. Do you have any plans to resume employment, affiliation, or practice with any of your previous employers, business firms, partnerships, associations, or other organizations after completing government service? (If yes, provide full details.)

No.

10. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, provide full details.)

No.

11. Describe fully all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

See Attachment B.

12. Explain in detail how you will resolve and avoid any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relating to the position for which you have been nominated and what actions you will take to resolve and avoid these actual or potential conflicts of interest.

Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department of Agriculture's designated agency ethics official and that has been provided to this Committee.

13. Fully describe and explain all divestitures or arrangements of any nature with respect to any type of interest that you have made or will make to resolve and avoid actual or potential conflicts of interest relating to the position for which you have been nominated.

Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Department of Agriculture's designated agency ethics official and that has been provided to this Committee.

Attachment A
Speaking Engagements 2007-2009

| <i>Date</i> | <i>Org</i> | <i>Location</i> | <i>Details</i> |
|-------------------------|-------------------------------|---------------------------|---|
| June 27 07 | Elk head Reservoir Dedication | Elk head Reservoir | Keynote Speaker |
| July 18 07 | Greenway Foundation | Confluence Park | Dedication |
| Aug. 15 07 | COGA speech | Convention Center | Keynote Speech |
| Aug. 17 07 | Grouse Talk | 719 | Endangered Species speech |
| Sept 25 07 | Douglas County Water Summit | Wildlife Experience | Keynote Lunch Address |
| Sept. 9 07 | Colo Ground Water Conference | Colorado Springs | Keynote Address |
| Nov. 9 07 | Denver Water Authority | Renaissance Denver Hotel | Keynote Speech--Future Water Supply Sources |
| May 17 08 | Colorado Cooperation | Devils Thumb, Tabernash | Colorado's Water Future |
| June 18 08 | Denver Chamber | 1445 Market Street | Water for Colorado's cities and agriculture communities. |
| Oct 23 rd | South Platte Forum | Radisson Longmont | Keynote Luncheon Speaker -Imagining Colorado's Water Future |
| Jan 8 th '09 | Action 22 | Pueblo Marriott | Keynote luncheon Speaker- The Future of Colorado's Water |
| Jan. 29 '09 | CWC | Hyatt Regency Tech Center | The Water Buffalo Stampede speech |

143

Attachment B

Describe fully all matters and all employers, clients, organizations, or interests you represented over the past five years before the Department of Agriculture or any of its agencies, or before Congress involving matters within the jurisdiction of this Committee or the Department of Agriculture.

From September, 2004 until February, 2007 while practicing law at Arnold & Porter, I represented the following entities before the Forest Service and USDA.

1. On behalf of Vail Resorts Management
 - a. Review of the Breckenridge Ski Area Peak 8 lift expansion
 - b. On behalf of Vail Resorts, appeal of the White River Forest Plan
 - c. Submission of comments concerning certain White River Forest Plan revisions.

2. On behalf of CNL Real Estate Investment Trust
 - a. Negotiation with the Forest Service, Booth Creek, and CNL regarding Forest Service reissuance of ski resort permits for resulting from sale of resorts.

3. On behalf of Copper Mountain Ski Resort
 - a. Resolution of third party timber patent claims within the Copper Mountain Ski Area boundaries.
 - b. Resolution of snowmaking proposals accompanying a Copper Mountain master development plan.

From February, 2007 until the present, while serving as Director of the Colorado Department of Natural Resources, I have periodically met with representatives of the Forest Service and USDA on a wide variety of federal/state policy and programmatic issues within the existing jurisdiction of the State and/or the Forest Service. These issues have included:

1. Coordination with the Forest Service on a wide variety of fuel reduction, forest restoration projects, and fire fighting plans and strategies.
2. Coordination on wide-array of Colorado's forest and natural resources issues including work on threatened and endangered species issues within a number of Colorado's national forests.



United States
Office of Government Ethics
1201 New York Avenue, NW, Suite 500
Washington, DC 20005-3917

September 18, 2009

The Honorable Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Harris Sherman, who has been nominated by President Obama for the position of Under Secretary for Natural Resources and Environment, Department of Agriculture. Mr. Sherman also has been nominated for the position of Member of the Board of Directors, Commodity Credit Corporation.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

Robert J. Cusick
Director

Enclosures

September 16, 2009

Mr. Raymond J. Sheehan
Designated Agency Ethics Official
U.S. Department of Agriculture
Washington, DC 20250-0122

Dear Mr. Sheehan:

The purpose of this letter is to explain the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Under Secretary for Natural Resources and Environment, U.S. Department of Agriculture (USDA). Holding the position of the Under Secretary for Natural Resources and Environment also entails a membership on the Board of Directors of the Commodity Credit Corporation (CCC). The steps detailed below also take into account any potential conflicts or appearances thereof associated with that CCC position.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any other person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to section 208(b)(1), or qualify for a regulatory exemption, pursuant to section 208(b)(2). I further understand that the interests of the following persons are imputed to me: any spouse or minor child of mine, any general partner of a partnership in which I am a limited or general partner, any entity in which I serve as officer, director, trustee, general partner, or employee; and any person or entity with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position as Executive Director, Colorado Department of Natural Resources. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Colorado Department of Natural Resources, is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d). I will continue to participate in the Colorado Public Employees Retirement Association, a defined benefit plan. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the ability or willingness of the State of Colorado to provide this contractual benefit to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208 (b)(2), such as 5 C.F.R. § 2640.201(c)(2).

Upon confirmation, I will resign my position as Trustee of the Boettcher Foundation. For a period of one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which the Boettcher Foundation, is a party or represents a party unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d).

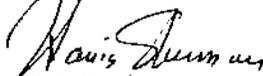
I will remain a non-managing partner in the A&P Realty Associates General Partnership ("A & P"). The partnership is invested in one holding, Plaza on Harvest Hill, LP, a multi-unit apartment building in Dallas, Texas. During my appointment to the position of Under Secretary, I will not provide any services to A&P. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of A&P or Plaza on Harvest Hill, LP, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that, pursuant to 18 U.S.C. § 208(a), the financial interests of each general partner in A&P will be imputed to me during my government service. For the duration of my appointment, I will not participate personally and substantially in any particular matter in which I know that any of these partners has a financial interest, if the particular matter has a direct and predictable effect on that interest, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

As a result of my retirement from Arnold and Porter LLP, I receive monthly retirement income from an unfunded retirement account. My monthly retirement income is based upon the number of years of service with Arnold and Porter LLP. I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of Arnold and Porter, LLP, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1).

I will divest all of my interests in the following Morgan Stanley Managed Accounts within 90 days of confirmation: Northern Trust Value Investors; Davis Advisors; Tradewinds Global; and Madison Large Cap Growth. Within each of these accounts are specific assets directly involved with oil and gas exploration, mining and forest management. Specifically, Deere Company; Waste Management, Inc.; BP; Chevron; ConocoPhillips; Devon Gas Services; Exxon Mobil; Occidental Petroleum; Barrick Gold; Baker Hughes and Newmont Mining pose a conflict of interest. Due to the structure of each managed account it is not feasible for me to divest of the specific holdings that pose a conflict of interest and therefore liquidating each managed account is necessary. With regard to each of the specific assets identified above, I will not participate personally and substantially in any particular matter that has a direct and predictable effect on the financial interests of the entity until I have divested it, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2).

Finally I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to commitments I have made in this and any other ethics agreement.

Sincerely,



Harris Sherman

Executive Branch Personnel PUBLIC FINANCIAL DISCLOSURE REPORT

| Date of Appointment, Candidacy, Election, or Nomination (Month, Day, Year) | | Reporting Status (Check appropriate box) | Calendar Year Covered by Report | New Entrant, Nominee, or Candidate <input checked="" type="checkbox"/> | Termination Date (If Applicable) (Month, Day, Year) | For Late Filing |
|---|--|---|---------------------------------|---|---|---|
| | | Incumbent <input type="checkbox"/> | | Termination Date (If Applicable) (Month, Day, Year) <input type="checkbox"/> | | Any individual who is required to file this report and does so more than 30 days after the date the report is required to be filed, or, if an extension is granted, more than 30 days after the last day of the filing extension period shall be subject to a \$200 fee. |
| Reporting Individual's Name | | Last Name SHERMAN | | First Name and Middle Initial HARRIS | | Reporting Periods Termination Filers: The reporting period is the preceding calendar year except Part D of Schedule C and Part I of Schedule D where you must also include the filing year up to the date you file. Part II of Schedule D is not applicable. |
| Position for Which Filing | | Title of Position Under Secretary for Natural Resources & Environment | | Department or Agency (If Applicable) U.S. Department of Agriculture | | |
| Location of Present Office (or forwarding address) | | Address (Number, Street, City, State, and ZIP Code) CO Dept. of Natl Resources, 1313 Sherman St., Denver, CO 80203 | | Telephone No. (Include Area Code) 303-866-3111 Ext. 8670 | | Termination Filers: The reporting period begins at the end of the period covered by your previous filing and ends at the date of termination. Part II of Schedule D is not applicable. |
| Position(s) Held with the Federal Government During the Preceding 12 Months (If Not Same as Above) | | Title of Position(s) and Date(s) Filed | | | | |
| Presidential Nominations Subject to Senate Confirmation | | Name of Congressional Committee Considering Nomination Committee on Agriculture, Nutrition and Forestry | | Do You Intend to Create a Qualified Diversified Trust? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | | Nominees, New Entrants and Candidates for President and Vice President. Schedule A - The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. |
| Certification | | Signature of Reporting Individual <i>Harris D. Sherman</i> | | Date (Month, Day, Year) 7/31/09 | | |
| Other Review (If desired by agency) | | Signature of Other Reviewer | | Date (Month, Day, Year) | | Schedule B - The reporting period for income (BLOCK C) is the preceding calendar year and the current calendar year up to the date of filing. Value assets as of any date you choose that is within 31 days of the date of filing. |
| Agency Ethics Official's Opinion (On the basis of information contained in this report, I conclude that the filer is in compliance with applicable laws and regulations (subject to any comments in the box below)) | | Signature of Designated Agency Ethics Official (Reviewing Official) <i>A. K. [Signature]</i> | | Date (Month, Day, Year) 8/27/09 | | |
| Office of Government Ethics Use Only | | Signature <i>[Signature]</i> | | Date (Month, Day, Year) 7/15/09 | | Schedule C - Part II (Agreements or Arrangements) - Show any agreements or arrangements as of the date of filing. Schedule D - The reporting period is the preceding two calendar years and the current calendar year up to the date of filing. |
| Comments of Reviewing Officials (If additional space is required, see the reverse side of this sheet) | | | | | | |
| | | | | (Check box if filing extension granted & indicate number of days) <input type="checkbox"/> | | Agency Use Only |
| | | | | (Check box if comments are continued on the reverse side) <input type="checkbox"/> | | DOGE Use Only |
| | | | | | | SEP 18 2009 |

149

155 of 308

Reporting Individual's Name
 Sharman, Harris

SCHEDULE A

Page Number
 2

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | |
|---|---|---------------------|----------------------|-----------------------|-------------------|----------------------------|-------------------|----------------|---|-------------------|--------------------|---------------------|---------------|-------------------|------------------|--|---|
| | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | Over \$1,000,000* | \$5,000,001 - \$25,000,000 | Over \$25,000,000 | Excluded Trust | Type | Amount | | | | | | | Other Income (Specify Type & Actual Amount) |
| For you, your spouse, and dependent children, report each asset held for investment or the production of income which had a fair market value exceeding \$1,000 at the close of the reporting period, or which generated more than \$200 in income during the reporting period, together with such income. For yourself, also report the source and actual amount of earned income exceeding \$200 (other than from the U.S. Government). For your spouse, report the source but not the amount of earned income of more than \$1,000 (except report the actual amount of any honoraria over \$200 of your spouse). None <input type="checkbox"/> | | | | | | | | | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$50,000 | Over \$50,000 | Over \$1,000,000* | Over \$5,000,000 | | |
| Examples Central Airlines Common Doe Jones & Smith, Hometown, State Kempstone Equity Fund IRA: Heartland 500 Index Fund | | | X | | | | | X | None (or less than \$201) | | | | | | | | |
| 1 MORGAN STANLEY ACTIVE ASSETS TAX FREE TRUST (money market fund) | | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 2 DISCOVER FINANCIAL SERVICES COMMON | X | | | | | | | X | None (or less than \$201) | | | | | | | | |
| 3 MORGAN STANLEY COMMON | | | | | | | | | None (or less than \$201) | | | | | | | | |
| 4 PIMCO COMM REAL RETURN | | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 5 AMERICAN FUNDS FUNDAMENTAL INVESTORS A | | | | | | | | | None (or less than \$201) | | | | | | | | |
| 6 UNIT LIMIT MUNI INSD CO 63SPS (municipal bond) | | | | | | | | X | None (or less than \$201) | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Filing Cannot be Used

150

156 of 308

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **3**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead | |
|--|---|--------------|-------------------|-------------------|--------------------|---------------------|---------------------|----------------|---|----------|---------------------------|-------------------|-------------------|--------------------|---------------------|---|---|---------------|
| | None <input type="checkbox"/> | \$0-\$10,000 | \$10,001-\$25,000 | \$25,001-\$50,000 | \$50,001-\$100,000 | \$100,001-\$250,000 | \$250,001-\$500,000 | Over \$500,000 | Dividends | Interest | None (or less than \$201) | Amount | | | | | | |
| | | | | | | | | | | | | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | | | Over \$25,000 |
| 1 FRANKLIN PORTFOLIO ADVISORS MUNICIPAL MANAGED ACCT. MORGAN STANLEY M&I ACCT. | | X | | | | | | | X | | | | | | | | | |
| 2 DENVER CO CITY & CNTY BRD WTR COMMS WTR BOND DUE 12/1/13 | | | | | | | | | X | | | | X | | | | | |
| 3 CMC ACADEMIC FACLS LEASING TR CO CTFS PARTN. BOND DUE 8/1/15 | | | | | | | | | X | | | | X | | | | | |
| 4 BOULDER CNTY CO DEV REV UNIV CORP FOR ATMOSPHERIC RESEARCH BOND DUE 9/1/15 | | | | | | | | | X | | | | X | | | | | |
| 5 COLORADO SPRINGS CO UTILS REV B BOND DUE 11/15/15 | | | | | | | | | X | | | | X | | | | | |
| 6 DENVER CO CITY AND CNTY GENL OBLIG DUE 8/1/17 | | | | | | | | | X | | | | X | | | | | |
| 7 ADAMS 12 FIVE STAR SCHOOLS CO CTFS PARTN BOND DUE 12/1/17 | | | | | | | | | X | | | | X | | | | | |
| 8 CO. WTR RES PWR DEV AUTH BOND DUE 9/1/18 | | | | | | | | | X | | | | X | | | | | |
| 9 CASTLE ROCK, CO WTR & SWR ENTERPRISE REVBOND DUE 12/1/19 | | X | | | | | | | X | | | | X | | | | | |

* This category applies only if the asset/income is jointly that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Print Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | | |
|-----------------------------|--|-------------------------|-----------------------|--------------------|----------------------------|-------------------|----------------|-----------|--|---------------------------|-------------------|---------------------|----------------------|------------------|------------------|---|--|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | 4 | | | | | |
| BLOCK A | Valuation of Assets at close of reporting period | | | | | | | BLOCK C | Income: type and amount. If "None (or less than \$200)" is checked, no other entry is needed in Block C for that item. | | | | Date (Mo., Day, Yr.) | Only if Honorary | | | |
| | BLOCK B | | | | | | | | Type | Amount | | | | | | | |
| | Over \$1,000,000 | \$500,001 - \$1,000,000 | \$250,001 - \$500,000 | Over \$1,000,000 * | \$5,000,001 - \$15,000,000 | Over \$50,000,000 | Exempted Trans | Dividends | Interest | None (or less than \$200) | \$1,001 - \$1,500 | \$15,001 - \$15,000 | \$50,001 - \$100,000 | Over \$1,000,000 | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | |
| 1 | | X | | | | | | | X | | | | | | | | |
| 2 | | | | | | | | | X | | | | | | | | |
| 3 | | | | | | | | | X | | | | | | | | |
| 4 | | | | | | | | | X | | | | | | | | |
| 5 | | | | | | | | | X | | | | | | | | |
| 6 | | | | | | | | | X | | | | | | | | |
| 7 | | | | | | | | | X | | | | | | | | |
| 8 | | | | | | | | | X | | | | | | | | |
| 9 | X | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **5**

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK D Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | |
|--|---|----------------|----------------------|-----------------------|-------------------------|------------------|------------------|---|----------|---------------------------|-------------------|-------------------|--------------------|----------------------|----------------|---|---|--|
| | None <input type="checkbox"/> | \$0 - \$10,000 | \$10,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 | Over \$5,000,000 | Dividends | Interest | None (or less than \$201) | Amount | | | | | Other Income (Specify Type & Actual Amount) | Date Acq. / Dis. / Ir. / Only if Retained | |
| | | | | | | | | | | | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$100,000 | Over \$100,000 | | | |
| 1 A.L.S.T.A.C.E CORP | | | | | | | | | | X | | | | | | | | |
| 2 AMERICAN EXPRESS CO. ANHEUSER BUSCH CO INC | X | | | | | | | X | | X | | | | | | | | |
| 3 ANACONDA DEVICES | X | | | | | | | | | X | | | | | | | | |
| 4 AT&T INC | X | | | | | | | X | | | | X | | | | | | |
| 5 BAKER HUGHES | X | | | | | | | | | X | | | | | | | | |
| 6 BANK OF NEW YORK MELLON CORP | X | | | | | | | | | X | | | | | | | | |
| 7 BLACK AND DECKER CORP | X | | | | | | | | | X | | | | | | | | |
| 8 BLACKROCK INC | X | | | | | | | | | | | X | | | | | | |
| 9 BOEING CO | X | | | | | | | X | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent child(ren). If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child(ren), mark the other higher categories of value, as appropriate.
 Prior 2010 Values Cannot be Used.

Reporting Individual's Name

SHERMAN, HARRIS

SCHEDULE A continued

(Use only if needed)

Page Number

6

| BLOCK A | BLOCK B | | | | | | | BLOCK C | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Required | |
|---------------------------------------|--|---------------------|---------------------|----------------------|-------------------|------------------|-------------------|--|-----------|----------|---------------------------|-------------------|--------------------|---------------------|---|--|---------------|
| | Valuation of Assets at close of reporting period | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | |
| | \$0 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$1,000,000* | Over \$2,000,000 | Over \$50,000,000 | Exempted Trust | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$10,000 | \$10,001 - \$25,000 | | | Over \$25,000 |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | |
| 1 BRISTOL MYERS SQUIBB CO | X | | | | | | | | | X | | | | | | | |
| 2 CHEVRON | X | | | | | | | | | X | | | | | | | |
| 3 CHUBB CLEAR CHANNEL COMM | X | | | | | | | X | | X | X | | | | | | |
| 4 COCA COLA CO | X | | | | | | | | | X | | | | | | | |
| 5 DEERE & CO DEUTSCHE TELEKO AG I ORD | X | | | | | | | X | | X | X | | | | | | |
| 6 DOW CHEMICAL CO | X | | | | | | | X | | | | | | | | | |
| 7 ENCAN CORP | X | | | | | | | | | X | | | | | | | |
| 8 ERICSSON LM TEL ADR CL B | X | | | | | | | | | X | | | | | | | |
| 9 EXXON MOBIL CORP | X | | | | | | | | | X | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.

Prior Editions Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **7**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Amount, Annual) | Date (Mo., Day, Yr.) Only if Hourly |
|--|---|---------------------|----------------------|-----------------------|-------------------------|---------------------------|----------------------------|-------------------|-------------------|------|--|-------------------|---------------------------|---------------------|----------------------|----------------|------------------|--|--|
| | | | | | | | | | | | Type | | | | | | | | |
| | | | | | | | | | | | Dividends | Interest | None (or less than \$201) | Amount | | | | | |
| | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$5,000,000 | \$5,000,001 - \$25,000,000 | Over \$25,000,000 | Exception: Trusts | None | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$5,000,000 | | |
| 1 GAP INC | X | | | | | | | | | | | | | | | | | | |
| 2 GENERAL ELECTRIC CO. | | | | | | | | | X | | | | | | | | | | |
| 3 GOLDMAN SACHS GRP INC H&R BLOCK | | | | | | | | | X | | | | X | | | | | | |
| 4 HARTFORD FIN SERS GRP INC HERSHEY | X | | | | | | | | X | | | | X | | | | | | |
| 5 HOME DEPOT INC | X | | | | | | | | X | | | | | | | | | | |
| 6 HUDSON CITY BANCORP INC | X | | | | | | | | X | | | | | | | | | | |
| 7 INTEL CORP | X | | | | | | | | X | | | | | | | | | | |
| 8 INTERNATIONAL BUSINESS MACHINES INC | X | | | | | | | | X | | | | | | | | | | |
| 9 JOHNSON & JOHNSON | X | | | | | | | | X | | | | X | | | | | | |

* This category applies only if the asset-income is solely that of the filer's spouse or dependent children. If the asset-income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

161 of 308

Reporting Individual's Name: **SHERMAN, HARRIS** SCHEDULE A continued Page Number: **B**
 (Use only if needed)

| BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homestead |
|--|---|------------------|----------------|----------------|---------------|---------------|--------------|---|--------|--------|--------|--------|--------|--|---|---|
| | None <input type="checkbox"/> | Over \$1,000,000 | Over \$500,000 | Over \$100,000 | Over \$50,000 | Over \$10,000 | Over \$1,000 | Type | Amount | Amount | Amount | Amount | Amount | | | |
| 1 KRAFT FOODS INC CL A | X | | | | | | | Interest | | | | | | | | |
| 2 LOCKHEED MARTIN CORP | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 3 MCGRAW HILL COS INC | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 4 MEDTRONIC METLIFE | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 5 MICROSOFT CORP | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 6 NEW YORK COMMUNITY BAN CORP NIT DOCOMO INC SP ADR | X | | | | | | | Interest | | | | | | | | |
| 7 OMNICOM GROUP PENNY JC | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 8 PEPSICO | X | | | | | | | None (or less than \$201) | | | | | | | | |
| 9 PFIZER INC | X | | | | | | | None (or less than \$201) | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used.

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **9**

SCHEDULE A continued
 (Use only if needed)

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$200" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Hierarchic |
|---------------------------------------|---|-------------------|----------------------------|--------------------------|--------------------------|-------------------------|-----------------------------|--|----------|--------------------------|-------------------|-------------------|--------------------|---------------------|-------------------|------------------|--|---|--|
| | BLOCK B | Over \$1,000,000* | \$500,000.00 - \$1,000,000 | \$250,000.00 - \$500,000 | \$100,000.00 - \$250,000 | \$50,000.00 - \$100,000 | None for less than \$50,000 | Type | | Amount | | | | | | | | | |
| | | | | | | | | Dividends | Interest | None for less than \$200 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | Over \$25,000.00* | Over \$5,000,000 | | | |
| 1 PHILIP MORRIS INTL INC | X | | | | | | | X | | | | | | | | | | | |
| 2 PROCTER AND GAMBLE | X | | | | | | | | | X | | | | | | | | | |
| 3 SANOFI-AVENTIS ADS | X | | | | | | | X | | | | | | | | | | | |
| 4 SCHLUMBERGER LTD | X | | | | | | | | | X | | | | | | | | | |
| 5 SUNOCO INC UNITED PARCEL SERVICE | X | | | | | | | X | | X | | | | | | | | | |
| 6 VERIZON COMMUNICATIONS | X | | | | | | | X | | X | | | | | | | | | |
| 7 WALMART STORES INC | | | | | | | | | | | X | | | | | | | | |
| 8 WELLS FARGO & CO | X | | | | | | | X | | | | | | | | | | | |
| 9 WYETH | | | | | | | | X | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the upper right categories of value, as appropriate.
 *Prior Ex-Rates Cannot be Used.

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | Page Number | |
|---|--|----------------------|-----------------------|------------------|---------------------|----------------|----------------|---|-----------|----------|---|----------------------|------------------|--|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | | 10 | |
| Assets and Income | Valuation of Assets as close of reporting period | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | |
| | BLOCK B | | | | | | | BLOCK C | | | | | | |
| BLOCK A | \$1,001 - \$150,000 | \$50,001 - \$100,000 | \$250,001 - \$500,000 | Over \$1,000,000 | \$5,001 - \$100,000 | Over \$250,000 | Over \$500,000 | None for less than \$201 | Dividends | Interest | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) | Only if Homocare | |
| None <input type="checkbox"/> | | | | | | | | | | | | | | |
| 1 MORGAN STANLEY DAVIS ADVISORS MANAGED ACCT. | | | | | | | | | | | | | | |
| 2 MORGAN STANLEY MONEY MARKET ACCT. | | | | | | | | X | | | | | | |
| 3 AGILENT TECHNOLOGIES | X | | | | | | | X | | | | | | |
| ALTRIA GROUP INC | | | | | | | | X | | | | | | |
| AMERICAN EXPRESS | | | | | | | | X | | | | | | |
| 4 AMERIFRISE FINANCIAL INC | X | | | | | | | X | | | | | | |
| ADN CORP | | | | | | | | X | | | | | | |
| 5 BANK OF NEW YORK MELLON | | | | | | | | | | X | | | | |
| 6 BECTON DICKSON & CO | X | | | | | | | | | X | | | | |
| 7 BED, BATH AND BEYOND | X | | | | | | | | | X | | | | |
| 8 BERKSHIRE HATHAWAY B | X | | | | | | | | | X | | | | |
| CANADIAN NATURAL RESOURCES LTD | X | | | | | | | | | X | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Price Edits may be used.

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)*" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | |
|--|---|--------------------|---------------------|----------------------|-----------------------|-------------------|------------------|--|-----------|----------|----------------------------|-------------------|--------------------|---------------------|---|--|---------------|
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | Over \$1,000,000* | Over \$5,000,000 | Category Trust | Type | | | Amount | | | | | |
| | | | | | | | | | Dividends | Interest | Rents (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$50,000 | | | Over \$50,000 |
| 1 CARDINAL HEALTHCARE INC | | X | | | | | | X | | | | | | | | | |
| 2 DISCO SYSTEM | | X | | | | | | | | | X | | | | | | |
| 3 COMCAST CORP CL A | | X | | | | | | | | | X | | | | | | |
| 4 CONOCOPHILLIPS COSTCO WHOLESALE CORP COVIDEN LTD | | | | | | | | X X X | | | | | | | | | |
| 5 CVS WHOLESALE CORP | | | | | | | | | | | X | | | | | | |
| 6 DEVON ENERGY CORP | | | | | | | | | | | X | | | | | | |
| 7 DIAGEO PLC SPON ADR | | X | | | | | | X | | | | | | | | | |
| 8 DUN & BRADSTREET CP | | X | | | | | | | | | X | | | | | | |
| 9 EOG RESOURCES INC | | | | | | | | X | | | | X | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 12

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | | BLOCK C Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary | | | |
|------------------------------------|---|---------------------|----------------------|-----------------------|-----------------------|-------------------|----------------------------|-------------------|---|-----------|----------|--------------------------|-------------------|-------------------|--------------------|--|---|----------------------|-------------------|------------------|
| | BLOCK B | | | | | | | | BLOCK C | | | | | | | | | | | |
| | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$1,000,000* | \$5,000,001 - \$10,000,000 | Over \$50,000,000 | Emergent Trust | Dividends | Interest | None for less than \$201 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | | | \$10,001 - \$100,000 | Over \$1,000,000* | Over \$5,000,000 |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | |
| 1 EXPRESS SCRIPTS INC | X | | | | | | | | | | | X | | | | | | | | |
| 2 GOOGLE INC | X | | | | | | | | | | | X | | | | | | | | |
| 3 GRUPO TELEVISIA SA GLOBAL DEP | X | | | | | | | | X | | | | | | | | | | | |
| 4 H&R BLOCK | X | | | | | | | | | | | X | | | | | | | | |
| 5 HARLEY DAVIDSON INC | X | | | | | | | | | | | X | | | | | | | | |
| 6 HEWLETT PACKARD | X | | | | | | | | | | | X | | | | | | | | |
| 7 IRON MOUNTAIN INC | X | | | | | | | | | | | X | | | | | | | | |
| 8 JOHNSON & JOHNSON | X | | | | | | | | | | | X | | | | | | | | |
| 9 JP MORGAN CHASE AND CO COMMON | X | | | | | | | | | | | X | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.

Pair Editions Cannot be Used

Reporting Individual's Name: **SHERMAN, HARRIS** Page Number: **13**

SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Historical |
|--------------------------------|---|-----------------------|-----------------------|-----------------------|-------------------------|---------------------------|------------------|---|----------|---------------------------|---------------|-------------------|-------------------|--------------------|----------------------|----------------|------------------|---|--|
| | | | | | | | | Type | | | | | | | | | | | |
| | \$100,001 - \$150,000 | \$150,001 - \$200,000 | \$200,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$5,000,000 | Over \$5,000,000 | Dividends | Interest | None (or less than \$201) | \$1 - \$1,000 | \$1,001 - \$1,500 | \$1,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$100,000 | Over \$100,000 | Over \$1,000,000 | | |
| Name: <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | |
| 1 LOEWS CORP | X | | | | | | | X | | | | | | | | | | | |
| 2 MERCK & CO | X | | | | | | | | | | X | | | | | | | | |
| 3 MICROSOFT | X | | | | | | | | | | X | | | | | | | | |
| 4 MCDYS CORP | X | | | | | | | X | | | | | | | | | | | |
| 5 NEWS CORP LTD/CL A | X | | | | | | | | | | X | | | | | | | | |
| 6 OCCIDENTAL PETROLEUM CORP | | | | | | | | X | | | | | | | | | | | |
| 7 PFIZER INC | X | | | | | | | | | | X | | | | | | | | |
| 8 PHILIP MORRIS INTL INC | X | | | | | | | X | | | | | | | | | | | |
| 9 PROCTER AND GAMBLE | X | | | | | | | | | | X | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Please Refer to Column 13 of Form 278e

| Reporting individual's Name SHERMAN, HARRIS | | SCHEDULE A continued (Use only if needed) | | | | | | | | | | Page Number 14 | | | | |
|--|---|--|-------------------|-------------------|-------------------|-------------------|-------------------|--|----------|---------------------------|-------------------|--------------------|--------------------|----------------|--|--|
| Assets and income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None or less than \$201" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | |
| | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | 100,001 - 100,000 | Dividends | Interest | None (or less than \$201) | \$1,001 - \$7,500 | \$7,501 - \$15,000 | \$15,001 - 100,000 | Over \$100,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day Yr.) Only if Honorary |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | |
| 1 PROGRESSIVE CORP OHIO | X | | | | | | | | X | | | | | | | |
| 2 SCHERING PLOUGH CORP | X | | | | | | | | X | | | | | | | |
| 3 SEALED AIR CP | X | | | | | | | | X | | | | | | | |
| 4 TEXAS INSTRUMENTS | X | | | | | | | | X | | | | | | | |
| 5 TRANSATLANTIC HOLDINGS INC | X | | | | | | | | X | | | | | | | |
| 6 TRANSOCEAN LTD | X | | | | | | | | X | | | | | | | |
| 7 TYCO INTERNATIONAL LTD | X | | | | | | | X | | X | | | | | | |
| 8 UNITED HEALTH GROUP INC | X | | | | | | | | X | | | | | | | |
| 9 VULCAN MATERIALS CO WALMART STORES | X | | | | | | | X | | X | X | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Power Edition Cannot be Used.

Reporting Period: 12/31/05
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Amount) | Date (Mo., Day, Yr.) Only if Honoraria | |
|---|---|--------------------|---------------------|----------------------|-------------------|----------------------------|-------------------|---|-----------|----------|---------------------------|-------------------|--------------------|---------------------|--------------------------------------|---|------------------|
| | None <input type="checkbox"/> | \$1,000 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | Over \$1,000,000* | \$5,000,001 - \$10,000,000 | Over \$50,000,000 | Keene Trust | Type | | | Amount | | | | | |
| | | | | | | | | | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$10,000 | \$10,001 - \$50,000 | | | Over \$1,000,000 |
| 1 WELLS FARGO & CO | | | | | | | | X | | | | | | | | | |
| 2 MORGAN STANLEY TRADEWINDS GLOBAL MANAGED ACCT MORGAN STANLEY MM ACCT | | | | | | | | X | X | | X | | | | | | |
| 3 AEGON NV ADR | X | | | | | | | X | | | | | | | | | |
| 4 ALCATEL LUCENT ADR | X | | | | | | | | | X | | | | | | | |
| 5 ALUMINA LTD | X | | | | | | | X | | | X | | | | | | |
| 6 ANGLGOLD ASHANTI LIMITED ASTRAZENZA | | | | | | | | X | | X | | | | | | | |
| 7 BARRICK GOLD CORP | | | | | | | | X | | | | X | | | | | |
| 8 BP PLC ADS | | | | | | | | X | | | | | | | | | |
| 9 CAMECO CORP | X | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent child. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Prior editions cannot be used.

Reporting individual's Name

SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 16

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day, Yr.) Only if Fluctuates |
|--|---|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|---|----------|---------------------------|--------------------|---------------------|----------------------|-----------------------|-----------------------|---|----------------|--|
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Dividends | Interest | None (or less than \$201) | Amount | | | | | Other Income (specify Type & Actual Amount) | | |
| | | | | | | | | | | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | | Over \$500,000 | |
| 1. CENTRAIS ELEC BRAS SP ADR CM CHUNGHWA TEL CO ADR CLP HOLDINGS LTD ADR | | X | | | | | | X | X | | | | | | | | | |
| 2. CURRENCY SHARES EURO YR | | X | | | | | | | | X | | | | | | | | |
| 3. CURRENCY SHARES JAPANESE YEN | | | | | | | | | | | | | | | | | | |
| 4. DAI NIPPON PRGT LTD JAPAN | | | | | | | | | | X | | | | | | | | |
| 5. DAIWA HOUSE IND LTD ADR ELECTROBRAS | | X | | | | | | | | X | | | | | | | | |
| 6. ENI SPA AMER DEP REC FUJIFILM HLOGS CORP ADR | | | | | | | | X | | X | | | | | | | | |
| 7. GOLD FIELDS LTD SP ADR | | X | | | | | | | | X | | | | | | | | |
| 8. HACHIJUNI BANK LTD ADR | | X | | | | | | | | X | | | | | | | | |
| 9. IMPALA PLATINUM HLDGS LTD | | X | | | | | | X | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is other than that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | Page Number | | | | | | |
|--|--|----------------------|-----------------------|-----------------------|-------------------|------------------|-------------------|---|-----------|----------|--------------------------|-------------------|--------------------|---------------------|-------------------|------------------|---|----------------------|------------------|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | | 17 | | | | | | |
| Assets and Income | Valuation of Assets at close of reporting period | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | |
| | BLOCK B | | | | | | | BLOCK C | | | | | | | | | | | |
| BLOCK A | None for less than \$1,001 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$1,000,000* | Over \$5,000,000 | Over \$25,000,000 | None for less than \$201 | Dividends | Interest | None for less than \$201 | \$1,001 - \$7,500 | \$7,501 - \$15,000 | \$15,001 - \$50,000 | Over \$1,000,000* | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) | Only if Homeless |
| 1. <input type="checkbox"/> Note: IVANHOE MINES LTD | X | | | | | | | | | | X | | | | | | | | |
| 2. KAO CORP SPONS ADR KINROSS GOLD ADR KIRIN BREWERY ADR | X | | | | | | | | X | | X | | | | | | | | |
| 3. KOREA ELECTRIC POWER CORP | X | | | | | | | | | | X | | | | | | | | |
| 4. KT CORP SPON ADR | X | | | | | | | | | | X | | | | | | | | |
| 5. LHIR GOLD LTD ADR LONMIN PLC ADR | X | | | | | | | | | | | | X | | | | | | |
| 6. MAGNA INTL A COM | X | | | | | | | | | | X | | | | | | | | |
| 7. MITSUBISHI TOMY LTD SPON ADR NEC ELECTRONICS ADR | X | | | | | | | | | | X | X | | | | | | | |
| 8. NEWCREST MINING LTD | X | | | | | | | | | | X | | | | | | | | |
| 9. NEWMONT MINING CORP | X | | | | | | | | X | | | | | | | | | | |

* This category applies only if the asset income is solely that of the filer's spouse or dependent children. If the asset income is either that of the filer or jointly held by the filer with the spouse or dependent children, the other higher categories of value, as appropriate.

Price Changes Cannot Be Used

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 16

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|--------------------------------|---|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|--|----------|---------------------------|-----------------|-------------------|-------------------|---------------------|-----------------------|-----------------|------------------|--|---|
| | | | | | | | | Type | | Amount | | | | | | | | | |
| | None <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Dividends | Interest | None (or less than \$201) | \$201 - \$1,000 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$100,000 | \$100,001 - \$500,000 | Over \$500,000* | Over \$5,000,000 | | |
| 1 NIKEN INC | | X | | | | | | X | | | | | | | | | | | |
| 2 NIPPON TELEGRAPH & TELEPHONE | | X | | | | | | X | | | | | | | | | | | |
| 3 NOKIA CP ADR | | X | | | | | | X | | | | | | | | | | | |
| 4 NOVARTIS AS ADR | | | | | | | | X | | | | | | | | | | | |
| 5 PANASONIC CORP SPON ADR | | X | | | | | | | | X | | | | | | | | | |
| 6 ROHM CO LTD UNSPONS ADR | | X | | | | | | | | | | | | | | | | | |
| 7 ROYAL DUTCH SHELL PLC | | | | | | | | X | | | | | | | | | | | |
| 8 SANOFI AVENTIS ADR | | | | | | | | | | X | | | | | | | | | |
| 9 SEGA SAMMY HDGS SPONS ADR | | X | | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Reporting Individual's Name
 SHEKMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date (Mo., Day Yr.) Only if Honorary | | | | | |
|---|---|-------------------|--------------------|----------------------|-------------------------|---------------------------|------------------|--|----------|---------------------------|-------------------|-------------------|--------------------|---------------------|---------------------|----------------------|----------------|--|------------------|---|--|--|--|
| | None <input type="checkbox"/> | \$1,001 - \$1,000 | \$1,001 - \$10,000 | \$10,001 - \$100,000 | \$100,001 - \$1,000,000 | \$1,000,001 - \$5,000,000 | Over \$5,000,000 | Dividends | Type | | Amount | | | | | | | | | | | | |
| | | | | | | | | | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | | Over \$5,000,000 | Other Income (Specify Type & Actual Amount) | | | |
| 1. SEKISUI HOUSE LTD ADR | X | | | | | | | | | X | | | | | | | | | | | | | |
| 2. SEVEN & T HOLDINGS CL LTD ADR | | | | | | | | | | X | | | | | | | | | | | | | |
| 3. SHISEIDO LTO SON ADR | X | | | | | | | | | X | | | | | | | | | | | | | |
| 4. SIEMENS AKTIENGES ZLLSHAF | X | | | | | | | | X | | | | | | | | | | | | | | |
| 5. SK TELECOM CO LTD | | | | | | | | | X | | | | | | | | | | | | | | |
| 6. SOCIETE GENERALE SP ADR STATOCHYDRO ADR | X | | | | | | | | | | | X | | | | | | | | | | | |
| 7. STORA ENSO SP ADR SER | X | | | | | | | | | X | | | | | | | | | | | | | |
| 8. SUMITOMO TR&BK CO | X | | | | | | | | | X | | | | | | | | | | | | | |
| 9. SUNCOR ENERGY INC | X | | | | | | | | X | | | X | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the other higher categories of value, as appropriate.
 Price Quotes Cannot Be Used

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 20

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Housing | | | | | |
|--|---|---------------|--------------------|---------------------|----------------------|----------------|----------------|--|-----------|----------|---------|---------------|---------------------------|-----------------|-------------------|--------------------|---------------------|--|--|---------------|----------------|----------------|--|--|
| | None | Under \$1,000 | \$1,001 - \$10,000 | \$10,001 - \$50,000 | \$50,001 - \$100,000 | Over \$100,000 | Over \$500,000 | None (or less than \$201) | Dividends | Interest | Rentals | Capital Gains | None (or less than \$201) | \$201 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$15,000 | \$15,001 - \$50,000 | | | Over \$50,000 | Over \$100,000 | Over \$500,000 | | |
| 1 SWISSCOM AG ADR | | | | | | | | X | | | | | | | | | | | | | | | | |
| 2 TDK CP ADR | | | | | | | | | | | | | X | | | | | | | | | | | |
| 3 TECHNIP-CORLEXIP | | X | | | | | | | | | | | | | | | | | | | | | | |
| 4 TELECOM ITALIA SPA NEW SHGS SHARES | | | X | | | | | X | | | | | | | | | | | | | | | | |
| 5 TOMKINS PLC ADS | | X | | | | | | | | | | | X | | | | | | | | | | | |
| 6 TOPPAN PRTG LTD ADR TOTAL FINA ELF SA | | X | | | | | | | | | | | X | | | | | | | | | | | |
| 7 UBS AG | | X | | | | | | | | | | | X | | | | | | | | | | | |
| 8 UNITED UTILITIES GROUP UPM KYMMENE CORP ADR | | X | | | | | | X | | | | | X | | | | | | | | | | | |
| 9 VODAFONE GP PLC ADS | | X | | | | | | X | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 † Prior Editions Cannot be Used.

Reporting Individual Name: **SHERMAN, HARRIS** Page Number: **21**
SCHEDULE A continued
 (Use only if needed)

| BLOCK A | Valuation of Assets at Close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honorary |
|--|--|----------------------|-----------------------|-------------------|----------------------------|-------------------|---------------|---|----------|--------------------------|-------------------|--------------------|----------------------|-------------------|------------------|--|--|---|--|
| | BLOCK C | | | | | | | | | | | | | | | | | | |
| | Type | | | | | Amount | | | | | | | | | | | | | |
| | \$100,001 - \$25,000,000 | \$50,001 - \$100,000 | \$250,001 - \$500,000 | Over \$1,000,000* | \$1,000,001 - \$25,000,000 | Over \$50,000,000 | Kept in Trust | Dividends | Interest | None for less than \$201 | \$1,001 - \$2,500 | \$5,001 - \$15,000 | \$50,001 - \$100,000 | Over \$1,000,000* | Over \$5,000,000 | | | | |
| 1 WACOAL CP ADR | X | | | | | | | X | | | | | | | | | | | |
| 2 WOLTERS KLUWER NV SHON ADR | X | | | | | | | | | X | | | | | | | | | |
| 3 MORGAN STANLEYMADISON LARGE CAP GROWTH MANAGED ACCT. | | | | | | | | | | X | | | | | | | | | |
| 4 MORGAN STANLEY MONEY MARKET ACCT 3M CO | | | | | | | | | X | | X | | | | | | | | |
| 5 ABB LTD | X | | | | | | | | | X | | | | | | | | | |
| 6 APLAG INCORPORATED | | | | | | | | X | | | | | | | | | | | |
| 7 APACHE CORP | X | | | | | | | | | X | | | | | | | | | |
| 8 BAXTER INTL INC | | | | | | | | | | X | | | | | | | | | |
| 9 BERKSHIRE HATHAWAY B | | | | | | | | | | X | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent child, mark the filer higher categories of value, as appropriate.
 Filer Elections Cannot be Used

175 of 308

Reporting Individual's Name
 SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number
 22

| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Homonant |
|--|---|---------------------|----------------------|-----------------------|-------------------------|--------------------|-----------------|--|----------|---------------------------|-------------------|--------------------|---------------------|---------------|--|---|
| | | | | | | | | BLOCK C | | | | | | | | |
| | | | | | | | | Type | Amount | | | | | | | |
| | \$1 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 * | Keypassed Trust | Dividends | Interest | None (or less than \$201) | \$1,001 - \$2,500 | \$2,501 - \$15,000 | \$15,001 - \$50,000 | Over \$50,000 | Over \$5,000,000 | |
| 1 CHECK POINT SOFTWARE TECH | X | | | | | | | | | X | | | | | | |
| 2 CISCO SYS INC | | | | | | | | | | | | | | | | |
| 3 COCA COLA CO | X | | | | | | | X | | | X | | | | | |
| 4 COMCAST CORP CL A | X | | | | | | | | | | | | | | | |
| 5 COSTCO WHOLESALE CORP | X | | | | | | | | | X | | | | | | |
| 6 COVANCE INC | | | | | | | | | | | | | | | | |
| 7 DENTSPLY INTERNATIONAL | X | | | | | | | | | X | | | | | | |
| 8 DEVON ENERGY CORP | X | | | | | | | | | X | | | | | | |
| 9 DIAGEO SPON ADR DONALDSON CO. INC | | | | | | | | X | | | X | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher categories of value, as appropriate.
 Prior Entries Cannot be Used

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | Page Number | | | | |
|---|---|-----------------------------|-----------------------------|----------------------------|------------------|-------------------------|--------------------------|--|----------|--------------------------|--|-------------|--|---|--|--|
| SHERMAN, HARRIS | | (Use only if needed) | | | | | | | | | | 24 | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | Income, type and amount. If "None for less than \$201" is checked, an other entry is needed in Block C for that item. | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Applicable | | |
| | BLOCK B | | | | | | | BLOCK C | | | | | | | | |
| | Over \$50,000,000 | \$25,000,000 - \$50,000,000 | \$10,000,000 - \$25,000,000 | \$5,000,000 - \$10,000,000 | Over \$1,000,000 | \$100,000 - \$1,000,000 | None for less than \$201 | Type | Amount | | | | | | | |
| | | | | | | | | Dividends | Interest | None for less than \$201 | | | | | | |
| 1 NOVARTIS AG ADR PEPSICO PHARMACEUTICAL PROO ADR | | | | | | | | X | | X | | | | | | |
| 2 QUEST DIAGNOSTICS INC | | | | | | | | X | | | | | | | | |
| 3 SCHLUMBERGER LTD | | | | | | | | | | X | | | | | | |
| 4 STAPLES INC | | | | | | | | | | X | | | | | | |
| 5 STATE STREET CORP SYNOVUS FINANCIAL | | | | | | | | | | X | | | | | | |
| 6 TARGET CORP | | | | | | | | | | X | | | | | | |
| 7 WALGREEN CO | | | | | | | | | | X | | | | | | |
| 8 WALT DISNEY CO | | | | | | | | | | X | | | | | | |
| 9 WASTE MANAGEMENT INC | | | | | | | | | | X | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate.

Print Filers Name in Uppercase

Reporting Individual's Name

SHERMAN, HARRIS

SCHEDULE A continued
 (Use only if needed)

Page Number

25

| BLOCK A Assets and Income | BLOCK B Valuation of Assets at close of reporting period | | | | | | | BLOCK C Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | Date 26a. Day, 1c. / Only if Honorary |
|--|---|--------------------|---------------------|----------------------|-----------------------|-----------------------|----------------|---|----------|---------------------------|-------------------|-------------------|-------------------|--------------------|---------------|---|--|---|
| | Name <input type="checkbox"/> | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | Over \$500,000 | Dividends | Interest | None (or less than \$201) | Account | | | | | Other Income (Specify Type & Actual Amount) | | |
| | | | | | | | | | | | \$1,001 - \$1,000 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | Over \$10,000 | | | |
| 1 WELLS FARGO & CO YAHOO INC | | | | | | | | | | X | | | | | | | | |
| 2 ZIMMER HLDGS INC | | | | | | | | | | | | | | | | | | |
| 3 MORGAN STANLEY IRA HOLDINGS MORGAN STANLEY MONEY MARKET ACCT | | | | | | | | | X | | | | X | | | | | |
| 4 AMERICAN FUND, FUNDAMENTAL INVESTOR FUND | | | | | | | | | | | X | | | | | | | |
| 5 AMERICAN FUND, GROWTH FUND OF AMERICA | | | | | | | | | | X | | | | | | | | |
| 6 AMERICAN FUND WASHINGTON MUTUAL FUND | | | | | | | | | | | | X | | | | | | |
| 7 PNR 2003-77 DA (Fannie Mae) | | | | | | | | X | | | | X | | | | | | |
| 8 BLACKROCK INFLATION PROT BOND C | | | | | | | | | | X | | | | | | | | |
| 9 PIMCO COMM REAL REY STRAT C | | | | | | | | | | | | | | X | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.

Price Columns Cannot be Used

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name SHERMAN, HARRIS | SCHEDULE C | Page Number 28 |
|---|-------------------|--------------------------|

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out; loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None X

Category of Amount or Value (x)

| Creditor (Name and Address) | Type of Liability | Date Incurred | Interest Rate | Term if applicable | Category of Amount or Value (x) | | | | | | | | | | | | | | | | |
|--|--|---------------|---------------|---------------------|---------------------------------|-----------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|--|--|--|--|--|--|--|
| | | | | | \$15,001 - 100,000 | \$100,001 - 1,000,000 | Over 1,000,000 | | | | | | | |
| Examples: First District Bank, Washington, DC John Jones, 123 F St., Washington, DC | Mortgage on rental property, Delaware Promissory note | 1991 1998 | 8% 10% | 25 yrs at demand | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits.

None

| Status and Terms of any Agreement or Arrangement | Party | Date |
|--|--|-------|
| Example: Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/20. | One Jones & Smith, Hometown, State | 7/85 |
| 1 WILL RECEIVE \$350.00 IN MONTHLY PENSION BENEFITS UPON RETIREMENT FROM STATE OF COLORADO | COLORADO PUBLIC EMPLOYEES RETIREMENT ASSN. | 01/07 |
| 2 PARTNERS RETIREMENT PLAN BASED UPON NUMBER OF YEARS OF SERVICE. PLAN IS UNFUNDED. | ARNOLD AND PORTER LLP | 05/08 |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

176

182 of 308

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name SHERMAN, HARRIS | SCHEDULE D | Page Number 29 |
|---|-------------------|--------------------------|

Part I: Positions Held Outside U.S. Government

Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or

consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|---|----------------------------------|------------------------------|-----------------|-----------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 5/92 2/83 | Present 1/00 |
| 1 | ARNOLD AND PORTER LLP | LAW FIRM | PARTNER | 05/80 | 01/07 |
| 2 | STATE OF COLORADO, DEPT. OF NATURAL RESOURCES | STATE AGENCY | EXECUTIVE DIRECTOR | 02/07 | PRESENT |
| 3 | BOETTCHER FOUNDATION | NON-PROFIT COMMUNITY FOUNDATION | TRUSTEE | 04/02 | PRESENT |
| 4 | A&P REALTY ASSOCIATES GENERAL PARTNERSHIP | GENERAL PARTNERSHIP | NON-MANAGING GENERAL PARTNER | 1982 | PRESENT |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source

Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any

corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential Candidate or Presidential Candidate

None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|--|---|
| Examples: | Doe Jones & Smith, Hometown, State Mega University (client of Doe Jones & Smith), Hometown, State | Legal services Legal services in connection with university construction |
| 1 | STATE OF COLORADO | EXECUTIVE DIRECTOR, DEPARTMENT OF NATURAL RESOURCES |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used

177

183 of 308

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).

Jill Elaine (Maycumber-maiden) Sommers

2. Date and place of birth.

(b)(6)

Fort Scott, Kansas

3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).

Married to Michael J. Sommers – Policy Director for Republican Leader John Boehner, US Capitol

4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.

University of Oregon 1987-1988

University of Kansas 1988-1991

**Bachelor of Arts Degree awarded December of 2005
(Course work completed in 1991)**

5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.

Office of Senator Robert J. Dole (R-KS)

Intern - January 1991-May 1991 - Washington DC

Receptionist – May 1991-August 1992 - Washington DC

Regional Representative – August 1992-November 1994

Pittsburg, Kansas/Topeka, Kansas

Represented the Senator at various functions and assisted constituents with various requests and issues regarding the federal government.

Assistant to the Administrative Assistant - Washington DC

November 1994-August 1995

Assisted the AA in managing a staff of 25 legislative assistants and correspondents

Clark & Muldoon, P.C. - August 1995-February 1998
Legislative Assistant
Assisted two attorneys with agricultural related client business as well as general office management.

Taggart & Associates - March 1998–August 1998
Senior Associate
Principal contact for clients with legislative concerns on issues such as agriculture, health care, and telecommunications

Chicago Mercantile Exchange
Manager, Legislative and Regulatory Affairs – August 1998–January 2001
Associate Director, Government Affairs – January 2001–March 2004
Primarily responsible for monitoring regulatory matters pending before the federal government. Accompanied Members of Congress, Administration officials and congressional staff to Chicago as part of the CME educational visitation program.

International Swaps and Derivatives Association
August 2005 – August 2006
Policy Director and Head of US Government Affairs
Principal contact in Washington DC for ISDA member firms on a variety of over-the-counter derivatives issues.

Commodity Futures Trading Commission
August 2007-Present
Commissioner

6. Military Service: Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.

None

7. Government Service: State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.

Office of Senator Robert J. Dole 1991-1995
CFTC – appointed 2007-present

8. Honors and Awards: List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.

None

8. **Political Affiliation:** The statute creating the Commodity Futures Trading Commission requires that no more than three members be from the same political party. List your current political party registration or affiliation.

Republican

9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.

**Kansas Society of Washington DC - Treasurer
University of Kansas Alumni Association – Washington DC contact**

10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry or any other matters within the jurisdiction of this Committee and the Department of Agriculture.

The following speeches can be found on the CFTC website:

September 2, 2009

Statement of Commissioner Jill Sommers, Joint Meetings on Harmonization of Regulation

July 29, 2009

Statement by Commissioner Jill Sommers, Commodity Futures Trading Commission

July 28, 2009

Statement by Commissioner Jill Sommers, Commodity Futures Trading Commission

June 9, 2009

Speech by Commissioner Jill E. Sommers, The U.S. Regulatory Landscape: The View from Washington, FIA/FOA International Derivatives Expo, London

September 19, 2008

Remarks by Commissioner Jill E. Sommers, "Integrity of the Futures Markets and the Role of Transparency", Asia Derivatives Conference, Tokyo, Japan

July 29, 2008

Opening Statement Commissioner Jill Sommers Before CFTC Agricultural Advisory Committee, Commodity Futures Trading Commission Headquarters

July 15, 2008

Statement Commissioner Jill Sommers Regarding Global Markets Advisory Committee, Commodity Futures Trading Commission Headquarters

June 10, 2008

Remarks of Commissioner Jill Sommers Before the Energy Markets Advisory Committee, Commodity Futures Trading Commission Headquarters

April 22, 2008

Statement of Commissioner Jill Sommers, Agricultural Markets Roundtable, Commodity Futures Trading Commission Headquarters

March 11, 2008

Statement of Commissioner Jill Sommers Regarding the CFTC-SEC Memorandum of Understanding, U.S. Securities and Exchange Commission Headquarters

November 13, 2007

Remarks by Commissioner Jill Sommers Before the Futures Industry Association Law and Compliance Division and the New York City Bar Association, Futures Industry Association Law and Compliance Division and the New York City Bar Association

October 16, 2007

Speech by Commissioner Jill Sommers before the Futures Industry Association, Law and Compliance Luncheon, Futures Industry Association, Law and Compliance Luncheon

September 18, 2007

Remarks by Commissioner Jill Sommers on Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets, Commodity Futures Trading Commission Headquarters

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?

Yes

2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.

None

3. Have you ever received a government guaranteed student loan? If so, has it been repaid?

Yes – all loans have been repaid in full

4. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)

No

5. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)

No

6. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)

No

7. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Commodity Futures Trading Commission, or before Congress involving matters within the jurisdiction of this Committee or the Commodity Futures Trading Commission.

1998-2004 The Chicago Mercantile Exchange – futures regulation, CEA Reauthorization

**2005-2006 International Swaps and Derivatives Association –
OTC derivatives issues, OTC energy swaps. CEA Reauthorization.**

8. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.

If any conflicts are found, I will divest my interest

9. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.

Currently, no conflicts have been identified



United States
Office of Government Ethics
1201 New York Avenue, N.W., Suite 500
Washington, DC 20005-3917

July 27, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Jill E. Sommers, who has been nominated by President Obama for the position of Commissioner of the Commodity Futures Trading Commission.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert I. Cusick".

Robert I. Cusick
Director

Enclosure

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: Page Number:

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| Transaction Type (a) | Date (Mo, Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | | Certificate of Divestiture | | | | | |
|---|---------------------|---------------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|------|---------------------------|---------------------------|---------------------------|----------------------------|----------------------------|------|--|--|--|--|
| | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | Over | \$1,000,001 - \$1,000,000 | \$1,000,001 - \$2,000,000 | \$2,000,001 - \$5,000,000 | \$5,000,001 - \$25,000,000 | | Over | | | | |
| Example: <input checked="" type="checkbox"/> Mutual Airlines Common | 2/1/99 | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Source (Name and Address) | Brief Description | Value |
|--|---|----------------|
| Example: Nat'l Assn of Book Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$300 \$300 |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |

Prior Editions Cannot Be Used.

| | | | | | | |
|--|---|--|---|--|---------------------------------|-------------------------|
| Reporting Individual's Name Sommers, Jill E | | SCHEDULE C | | | | Page Number 6 |
| Part I: Liabilities | | | | | | |
| Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your | | personal residence unless it is rented out, loans secured by automobiles, household furniture or appliances, and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts. | | None <input checked="" type="checkbox"/> | Category of Amount or Value (x) | |
| | | Date Incurred | Interest Rate | Term if applicable | \$10,001 - \$15,000 | Over \$50,000 |
| Examples: | First District Bank, Washington, DC John Jones, 123 J St., Washington, DC | Mortgage on rental property, Delaware Promissory note | 1991 1999 | 8% 10% | 25 yrs. on demand | x x |
| 1 | | | | | | |
| 2 | | | | | | |
| 3 | | | | | | |
| 4 | | | | | | |
| 5 | | | | | | |
| * This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate. | | | | | | |
| Part II: Agreements or Arrangements | | | | | | |
| Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g., 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves | | | of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits | | | |
| | | | None <input checked="" type="checkbox"/> | | | |
| Status and Terms of any Agreement or Arrangement | | | Parties | | Date | |
| Example: | Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/00. | | Doe Jones & Smith, Hometown, State | | 7/85 | |
| 1 | | | | | | |
| 2 | | | | | | |
| 3 | | | | | | |
| 4 | | | | | | |
| 5 | | | | | | |
| 6 | | | | | | |

Prior Editions Cannot Be Used

| | | |
|---|-------------------|------------------|
| Reporting Individual's Name Summers, Jiff E. | SCHEDULE D | Page Number 7 |
|---|-------------------|------------------|

Part I: Positions Held Outside U.S. Government
 Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political entities and those solely of an honorary nature.

None

| | Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
|-----------|---------------------------------------|----------------------|---------------|-----------------|---------------|
| Examples: | Natl Assn. of Rock Collectors, NY, NY | Non-profit education | President | 6-92 | Present |
| | Doe Jones & Smith, Hometown, State | Law firm | Partner | 7-89 | 1-00 |
| 1 | | | | | |
| 2 | | | | | |
| 3 | | | | | |
| 4 | | | | | |
| 5 | | | | | |
| 6 | | | | | |

Part II: Compensation In Excess Of \$5,000 Paid by One Source
 Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.

Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential Candidate or Presidential Candidate
 None

| | Source (Name and Address) | Brief Description of Duties |
|-----------|---|---|
| Examples: | Doe Jones & Smith, Hometown, State | Legal services |
| | Mega University (client of Doe Jones & Smith), Moneytown, State | Legal services in connection with university construction |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |

Prior Editions Cannot Be Used

BIOGRAPHICAL INFORMATION (PUBLIC)

1. Full name (include any former names used).
Kenneth Albert Spearman
2. Date and place of birth.
(b)(6) East Chicago, Indiana
3. Marital Status: If married, list spouse's name (include any former names used), occupation, employer's name and business address(es).
Married to Maria Spearman (Hunyh Mo Khanh). Maria is a Personal Trainer who is self-employed and works out of our home at (b)(6)
(b)(6)
4. Education: List each college and graduate or professional school you have attended, including dates of attendance, degrees received, and dates degrees were granted.
-Governors State University, 9/1975 to 8/1978, Masters in Business Administration, 8/1978 (was working for Arthur Andersen & Co. while attending graduate school).
-Indiana University, 9/1970 to 8/1973, Bachelors of Science, 8/1973.
5. Employment and Self-Employment Record: List (by year) all business or professional corporations, companies, firms, or other enterprises, partnerships, institutions and organizations, nonprofit or otherwise, including farms or ranches, with which you were connected as an officer, director, partner, proprietor, or employee since graduation from college; include a title and brief job description.
 - 2006-present **AgFirst Farm Credit Bank - Appointed Director**
Serves as an appointed director on the board of AgFirst Farm Credit currently a member of the Governance Committee.
 - 2003-2006 **Lake Wales Medical Center - Board Member**
 - 1991-2007 **CITRUS WORLD, INC. - Director, Internal Audit**
Responsible for the design and implementation of annual plans for reviewing and appraising the soundness, adequacy, and application of accounting, financial, and other operating internal controls.
 - 1980-1991 **CITRUS CENTRAL, INC. - Controller, General Accounting**
Responsible for the financial management of reporting function for \$100+ million company with a staff of four accountants. Cash management, receivables, payables, payroll, credit, insurance, general ledger, financial statement preparation, budgets, treasury function, annual audit coordination are examples of areas within my purview.
 - 1976-1980 **JAMES WILLIAMS & CO. - Co-founder, Certified Public Accountants Firm**
Responsible for planning, directing and monitoring financial, compliance and operational audits for a wide variety of clients in both the private and public sectors. Managed financial and treasury/controllership functions performed by seven staff and senior accountants.

- 1973-1976 **ARTHUR ANDERSEN & CO.** - Audit Staff, Small Business Division
 Performed independent audit examinations at both the staff and project-lead levels, for clients in the manufacturing, hotel and not-for-profit sectors. Functions included audits, preparation of special reports, costs analysis, purchase investigations and tax preparation. Evaluations of internal controls and suggesting improvements along with drafting financial statements and disclosure footnotes were also performed.
6. **Military Service:** Have you had any military service? If so, give particulars, including the dates, branch of service, rank or rate, and type of discharge received.
Yes, from 06/1962 until 10/1965. I served in the US Army Intelligence Service attaining the rank of Specialist Fifth Class. My service number was 167 39 568 and I received an Honorable Discharge.
7. **Government Service:** State (chronologically) your government service or public offices you have held, including the terms of service, grade levels, and whether such positions were elected or appointed.
None.
8. **Honors and Awards:** List any scholarships, fellowships, honorary degrees, and honorary society memberships that you received and believe would be of interest to the Committee.
Board of Directors resolution recognition from Citrus World, Inc. for faithful and dedicated service...2007, and the Award of Excellence from National Society of Accountants for Cooperatives...2003, and also received an award from Lake Wales Medical Center for servicing as Board Chairman....2005.
9. **Other Memberships:** If not covered above, list all organizations in which during the past 10 years you held a position as official, board member, or other leadership position and describe the position. Exclude religious organizations.
Institute of Internal Auditors, National Society of Accountants for Cooperatives, Florida Farm Bureau.
10. **Published Writings:** List the titles, publishers, and dates of books, articles, reports, or other published materials (including published speeches) you have written. Please include on this list published materials on which you are listed as the principal editor. It would be helpful to the Committee if you could provide one copy of all published material that may not be readily available. Also, to the maximum extent practicable, please supply a copy of all unpublished speeches you made during the past five years on issues involving agriculture, nutrition, forestry, agricultural credit, or other matters within the jurisdiction of this Committee or the Farm Credit Administration.

Membership articles written and published in the National Society of Accountants for Cooperatives newsletter (News and Views) while serving as the groups National President (listed below). The articles published were of an administrative, motivational and strategic planning nature written quarterly during my one year term. Please see attached a copy of each quarterly newsletter with my message on

front page. The list below is a complete listing of all my published writings.

- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Fall 2002).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Winter 2002).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Spring 2003).
- "President's Message," *News & Views*, National Society of Accountants for Cooperatives (Summer 2003).

FINANCIAL DATA AND CONFLICT OF INTEREST (PUBLIC)

1. Have you severed all connections with your immediate past private sector employers, business firms, associations, and/or organizations?
Under the terms of my ethics agreement, I will resign from my current employer upon confirmation by the Senate.
2. List sources, amounts and dates of all expected receipts from deferred income arrangements, stock options, uncompleted contracts, and other future benefits which you expect to derive from previous business relationships, professional services, firm memberships, former employers, clients, or customers.
Florida's Natural Growers, a division of Citrus World, Inc. \$123,500, one third of which to be received over the next three years. AgFirst Farm Credit Bank, \$34,000, one fourth of which to be received over the following four years after separation.
3. Do you, or does any partnership or closely held corporation in which you have an interest, own or operate a farm or ranch? (If yes, please give a brief description including location, size and type of operation.)
No.
4. Have you, or any partnership or closely held corporation in which you have an interest, ever participated in federal commodity income and price support programs? (If yes, provide all details including amounts of government payments and loans received or forfeited by crop and farm, et cetera during the past five years.)
No.
5. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from or guaranteed by any current or previously existing agency of the Department of Agriculture, including through any of the farm or rural development lending programs? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)
No.
6. Have you, or any partnership or closely held corporation in which you have an interest, ever received a loan or cosigned a note involving a loan from, involving, or handled by any current or previously existing institution regulated or overseen by the Farm Credit Administration? (If yes, please state the current status and details of such loans, whether they have been fully repaid, and all details of any such loan activity.)
No.
7. Have you, or any partnership or closely held corporation in which you have an interest, received payments for crop losses from the federal crop insurance program in the past 5

years? (If yes, give details.)

No.

8. Have you ever received a government guaranteed student loan? If so, has it been repaid?
Yes and they were repaid in full over 30 years ago.
9. If confirmed, do you have any plans, commitments, or agreements to pursue or continue outside employment or engage in or continue any business or vocation, with or without compensation, during your service with the government? (If so, explain.)
No.
10. Do you have any plans to resume employment, affiliation, or practice with your previous employers, business firms, associations, or organizations after completing government service? (If yes, give details.)
No.
11. Has anyone made a commitment to employ you or retain your services in any capacity after you leave government service? (If yes, please specify.)
No.
12. Describe all matters and all employers, clients, organizations, or interests you represented over the past five years before the Farm Credit Administration, or before Congress involving matters within the jurisdiction of this Committee, the Department of Agriculture, or the Farm Credit Administration.
None.
13. If confirmed, explain how you will resolve any actual or potential conflicts of interest, including any that may be disclosed by your responses to the above questions. In particular, identify all investments, obligations, liabilities, or other relationships that involve actual or potential conflicts of interest relative to the position for which you have been nominated and what actions you will take to resolve these actual or potential conflicts of interest if confirmed.
Any potential conflicts of interest will be resolved in accordance with the terms of an ethics agreement that I have entered into with the Farm Credit Administration's designated agency ethics official and that has been provided to this Committee. I am not aware of any other potential conflicts of interest.
14. Describe and explain all divestitures or arrangements, of any nature with respect to any type of interest, which you have made or will make to resolve actual or potential conflicts of interest should you be confirmed to the position for which you are nominated.
Upon confirmation to the FCA Board, I will resign from my position on the board of directors of the AgFirst Farm Credit Bank (AgFirst). I will also sign the Ethics Pledge required by the Obama administration.



United States
Office of Government Ethics
1201 New York Avenue, NW., Suite 500
Washington, DC 20005-3917

July 23, 2009

The Honorable Tom Harkin
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Kenneth A. Spearman, who has been nominated by President Obama for the position of Board Member of the Farm Credit Administration.

We have reviewed the report and have also obtained advice from the agency concerning any possible conflict in light of its functions and the nominee's proposed duties. Also enclosed is an ethics agreement outlining the actions that the nominee will undertake to avoid conflicts of interest. Unless a date for compliance is indicated in the ethics agreement, the nominee must fully comply within three months of confirmation with any action specified in the ethics agreement.

Based thereon, we believe that this nominee is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert J. Cusick".

Robert J. Cusick
Director

Enclosures

ETHICS AGREEMENT

July 21, 2009

Wendy R. Laguarda
Designated Agency Ethics Official & Assistant General Counsel
Office of General Counsel
FARM CREDIT ADMINISTRATION
1501 Farm Credit Drive
McLean, VA 22102-5090
(703) 883-4234

Dear Ms. Laguarda:

The purpose of this letter is to describe the steps that I will take to avoid any actual or apparent conflict of interest in the event that I am confirmed for the position of Board Member of the Farm Credit Administration.

As required by 18 U.S.C. § 208(a), I will not participate personally and substantially in any particular matter that has a direct and predictable effect on my financial interests or those of any person whose interests are imputed to me, unless I first obtain a written waiver, pursuant to 18 U.S.C. § 208(b)(1), or qualify for a regulatory exemption, pursuant to 18 U.S.C. § 208(b)(2). I understand that the interests of the following persons are imputed to me: any spouse or minor child of mine; any general partner of a partnership in which I am a limited or general partner; any organization in which I serve as officer, director, trustee, general partner or employee; and any person or organization with which I am negotiating or have an arrangement concerning prospective employment.

Upon confirmation, I will resign from my position on the board of directors of the AgFirst Farm Credit Bank (AgFirst). For one year after my resignation, I will not participate personally and substantially in any particular matter involving specific parties in which AgFirst is a party or represents a party, unless I am first authorized to participate, pursuant to 5 C.F.R. § 2635.502(d). In addition, I will cash out my deferred savings plan (Savings Plan) with AgFirst within 90 days of my confirmation.

Finally, I understand that as an appointee I am required to sign the Ethics Pledge (Exec. Order No. 13490) and that I will be bound by the requirements and restrictions therein in addition to the commitments I have made in this and any other ethics agreement.

Sincerely,



Kenneth A. Spearman

| Reporting Individual's Name | | SCHEDULE A | | | | | | | | | | | | Page Number | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|---|------------|--|--|--|--|--|--|--|--|--|--------|---|--|--|--|--|--|--|--|--|--|--|---|---|---|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|--|
| Kenneth A. Spearman | | | | | | | | | | | | | | 2 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Assets and Income BLOCK A | Valuation of Assets at close of reporting period BLOCK B | | | | | | | | | | | | Income: type and amount. If "None (or less than \$201)" is checked, no other entry is needed in Block C for that item. BLOCK C | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | Type | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | Amount | | | | | | | | | | | | Other Income (Specify Type & Actual Amount) | Date (Mo., Day, Yr.) Only if Honoraria | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| For you, your spouse, and dependent children, report each asset held for investment or the production of income which had a fair market value exceeding \$1,000 at the close of the reporting period, or which generated more than \$200 in income during the reporting period, together with such income. For yourself, also report the source and actual amount of earned income exceeding \$200 (other than from the U.S. Government). For your spouse, report the source but not the amount of earned income of more than \$1,000 (except report the actual amount of any honoraria over \$200 of your spouse). None <input type="checkbox"/> | | | | | | | | | | | | | | None (or less than \$1,001) \$1,001 - \$15,000 \$15,001 - \$50,000 \$50,001 - \$100,000 \$100,001 - \$250,000 \$250,001 - \$500,000 \$500,001 - \$1,000,000 Over \$1,000,000 * \$1,000,001 - \$5,000,000 \$5,000,001 - \$10,000,000 \$10,000,001 - \$50,000,000 Over \$50,000,000 | | | | | | | | | | | | Excepted Investment Fund Excluded Trust Qualified Trust Dividends Rent and Royalties Interest Capital Gains None (or less than \$201) \$201 - \$1,000 \$1,001 - \$5,000 \$5,001 - \$10,000 \$10,001 - \$25,000 \$25,001 - \$50,000 \$50,001 - \$100,000 \$100,001 - \$250,000 \$250,001 - \$500,000 \$500,001 - \$1,000,000 Over \$1,000,000 | | | | | | | | | | | | | | | | | | | | | | | | | |
| Examples: <ul style="list-style-type: none"> Common Stocks U.S. Gov't Bonds Municipal Bonds Foreign Bonds Real Estate Private Equity Funds IRA: Vanguard 500 Index Fund | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | IRA: Amer Bal Fund (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | IRA: Amer Mutual FD Inc (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | IRA: Amer Europacific Growth Fd (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | IRA: GoldmanSachs Growth Opps FD (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | IRA: Amer Growth Fund of America (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | IRA: Invest Co America (Wachovia Securities) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| * This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, mark the other higher category of value, as appropriate. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| † Prior Filings Cannot be Used. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

201

207 of 308

| Reporting Individual's Name | | SCHEDULE A continued | | | | | | | | | | | | Page Number | | | | | | | | | | | | | | | | |
|-------------------------------|---|--|--------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|------------------|------------------|------------------|---|-------------------|--------------------|--------------------------|-----------|----------|---------------|--------------------------|-----------------|-------------------|-------------------|--------------------|---------------------|---------------------|----------------------|-----------------------|----------------|--------------------------------------|--|
| Kenneth A. Spearman | | (Use only if needed) | | | | | | | | | | | | 10 | | | | | | | | | | | | | | | | |
| Assets and Income | BLOCK A | Valuation of Assets at close of reporting period | | | | | | | | | | Income: type and amount. If "None for less than \$201" is checked, no other entry is needed in Block C for that item. | | | | | | | | | | | | | | | | | | |
| | | BLOCK B | | | | | | | | | | BLOCK C | | | | | | | | | | | | | | | | | | |
| | | None for less than \$1,001 | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | Over \$1,000,000 | Over \$1,000,000 | Over \$5,000,000 | Over \$10,000,000 | Over \$50,000,000 | Over \$100,000,000 | None for less than \$201 | Dividends | Interest | Capital Gains | None for less than \$201 | \$201 - \$1,000 | \$1,001 - \$2,500 | \$2,501 - \$5,000 | \$5,001 - \$10,000 | \$10,001 - \$25,000 | \$25,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | Over \$250,000 | Other Income (Specify Type & Amount) | Date (Mo., Day, Yr.) Only if Honorary |
| None <input type="checkbox"/> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 | FNG Asset-MIST Multi/Small Cap Growth 1 1/2 | X | | | | | | | | | | | | X | | | | | | | | | | | | | | | | |
| 2 | FNG Asset-Morgan Stanley EAFE Index 22% | | X | | | | | | | | | | | X | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the asset/income is solely that of the filer's spouse or dependent children. If the asset/income is either that of the filer or jointly held by the filer with the spouse or dependent children, check the other higher categories of value, as appropriate.
 Prior Editions Cannot be Used

Do not Complete Schedule B if you are a new entrant, nominee, Vice Presidential or Presidential Candidate

Reporting Individual's Name: **Kenneth A. Spearman** Page Number: **11**

SCHEDULE B

Part I: Transactions None

Report any purchase, sale, or exchange by you, your spouse, or dependent children during the reporting period of any real property, stocks, bonds, commodity futures, and other securities when the amount of the transaction exceeded \$1,000. Include transactions that resulted in a loss. Do not report a transaction involving property used solely as your personal residence, or a transaction solely between you, your spouse, or dependent child. Check the "Certificate of divestiture" block to indicate sales made pursuant to a certificate of divestiture from OGE.

| Line | Identification of Assets | Transaction Type (x) | | | Date (Mo., Day, Yr.) | Amount of Transaction (x) | | | | | | | | | | | | |
|------|----------------------------------|----------------------|------|----------|----------------------|---------------------------|---------------------|----------------------|-----------------------|-----------------------|-------------------------|---------------------------|---------------------------|----------------------------|-----------------------------|-------------------|----------------------------|--|
| | | Purchase | Sale | Exchange | | \$1,001 - \$15,000 | \$15,001 - \$50,000 | \$50,001 - \$100,000 | \$100,001 - \$250,000 | \$250,001 - \$500,000 | \$500,001 - \$1,000,000 | \$1,000,001 - \$2,000,000 | \$2,000,001 - \$5,000,000 | \$5,000,001 - \$25,000,000 | \$25,000,001 - \$50,000,000 | Over \$50,000,000 | Certificate of Divestiture | |
| 1 | Example: Central Airlines Common | x | | | 2/1/99 | | | | x | | | | | | | | | |
| 2 | N/A | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | |

* This category applies only if the underlying asset is solely that of the filer's spouse or dependent children. If the underlying asset is either held by the filer or jointly held by the filer with the spouse or dependent children, use the other higher categories of value, as appropriate.

Part II: Gifts, Reimbursements, and Travel Expenses None

For you, your spouse and dependent children, report the source, a brief description, and the value of: (1) gifts (such as tangible items, transportation, lodging, food, or entertainment) received from one source totaling more than \$260; and (2) travel-related cash reimbursements received from one source totaling more than \$260. For conflicts analysis, it is helpful to indicate a basis for receipt, such as personal friend, agency approval under 5 U.S.C. § 4111 or other statutory authority, etc. For travel-related gifts and reimbursements, include travel itinerary, dates, and the nature of expenses provided. Exclude anything given to you by the U.S. Government; given to your agency in connection with official travel; received from relatives; received by your spouse or dependent child totally independent of their relationship to you; or provided as personal hospitality at the donor's residence. Also, for purposes of aggregating gifts to determine the total value from one source, exclude items worth \$104 or less. See instructions for other exclusions.

| Line | Source (Name and Address) | Brief Description | Value |
|------|---|---|----------------|
| 1 | Examples: Natl Assn. of Rock Collectors, NY, NY Frank Jones, San Francisco, CA | Airline ticket, hotel room & meals incident to national conference 6/15/99 (personal activity unrelated to duty) Leather briefcase (personal friend) | \$500 \$300 |
| 2 | N/A | | |
| 3 | | | |
| 4 | | | |
| 5 | | | |

Prior Editions Cannot Be Used

210

216 of 308

| | | |
|---|-------------------|--------------------------|
| Reporting Individual's Name Kenneth A. Spearman | SCHEDULE C | Page Number 12 |
|---|-------------------|--------------------------|

Part I: Liabilities

Report liabilities over \$10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent children. Check the highest amount owed during the reporting period. Exclude a mortgage on your

personal residence unless it is rented out, loans secured by automobiles, household furniture or appliances; and liabilities owed to certain relatives listed in instructions. See instructions for revolving charge accounts.

None

Category of Amount or Value (x)

| Creditor (Name and Address) | Type of Liability | Date Incurred | Interest Rate | Term of applic- cable | Category of Amount or Value (x) | | | | | | | | | | | | | | | |
|--|--|---------------|---------------|--------------------------|---------------------------------|------------------|------------------|-------------------|-------------------|---------------------|------|------|------|------|------|--|--|--|--|--|
| | | | | | \$10,001-\$100,000 | 100,001-\$50,000 | 50,001-\$100,000 | 100,001-\$250,000 | 250,001-\$500,000 | 500,001-\$1,000,000 | Over | None | None | None | None | | | | | |
| Examples: First District Bank, Washington, DC John Jones, 123 J St., Washington, DC | Mortgage on rental property, Delaware Promissory note | 1991 1999 | 8% 10% | 25 yrs. on demand | | | | | | | | | | | | | | | | |
| 1 | | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | | |

* This category applies only if the liability is solely that of the filer's spouse or dependent children. If the liability is that of the filer or a joint liability of the filer with the spouse or dependent children, mark the other higher categories, as appropriate.

Part II: Agreements or Arrangements

Report your agreements or arrangements for: continuing participation in an employee benefit plan (e.g. 401k, deferred compensation); (2) continuation payment by a former employer (including severance payments); (3) leaves

of absence; and (4) future employment. See instructions regarding the reporting of negotiations for any of these arrangements or benefits

None

| Status and Terms of any Agreement or Arrangement | Parties | Date |
|--|------------------------------------|-------|
| Example: Pursuant to partnership agreement, will receive lump sum payment of capital account & partnership share calculated on service performed through 1/00. | Doc Jones & Smith, Hometown, State | 7/85 |
| 1 Deferred Compensation Plan | Florida Natural Growers | 12/91 |
| 2 Defined Benefit Plan | Citrus Central | 10/80 |
| 3 Deferred Savings Plan | AqFirst Farm Credit Bank | 01/06 |
| 4 | | |
| 5 | | |
| 6 | | |

| | | | | |
|--|---|----------------------------|------------------------|----------------------|
| Reporting Individual's Name Kenneth A. Spearman | SCHEDULE D | Page Number 13 | | |
| <p>Part I: Positions Held Outside U.S. Government Report any positions held during the applicable reporting period, whether compensated or not. Positions include but are not limited to those of an officer, director, trustee, general partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or other business enterprise or any non-profit organization or educational institution. Exclude positions with religious, social, fraternal, or political affiliations and those solely of an honorary nature.</p> <p style="text-align: right;">None <input type="checkbox"/></p> | | | | |
| Organization (Name and Address) | Type of Organization | Position Held | From (Mo., Yr.) | To (Mo., Yr.) |
| <i>Examples:</i> Nat'l Assn. of Rock Collectors, NY, NY Doe Jones & Smith, Hometown, State | Non-profit education Law firm | President Partner | 6/92 7/85 | Present 1/00 |
| 1 AgFirst Farm Credit Bank, 1401 Hampton Street, Columbia, South Carolina 29202 | Bank | Board Director | 01/2006 | Present |
| 2 Florida's Natural Growers, 20205 US Hwy 27, Lake Wales, Florida 33853 | Citrus Marketer and Processor | Director of Internal Audit | 12/1991 | 12/2007 |
| 3 | | | | |
| 4 | | | | |
| 5 | | | | |
| 6 | | | | |
| <p>Part II: Compensation In Excess Of \$5,000 Paid by One Source Report sources of more than \$5,000 compensation received by you or your business affiliation for services provided directly by you during any one year of the reporting period. This includes the names of clients and customers of any corporation, firm, partnership, or other business enterprise, or any other non-profit organization when you directly provided the services generating a fee or payment of more than \$5,000. You need not report the U.S. Government as a source.</p> <p style="text-align: right;">Do not complete this part if you are an Incumbent, Termination Filer, or Vice Presidential or Presidential Candidate None <input type="checkbox"/></p> | | | | |
| Source (Name and Address) | Brief Description of Duties | | | |
| <i>Examples:</i> Doe Jones & Smith, Hometown, State Metro University (client of Doe Jones & Smith), Hometown, State | Legal services Legal services in connection with university construction | | | |
| 1 AgFirst Farm Credit Bank, 1401 Hampton street, Columbia, South Carolina 29202 | Board Director | | | |
| 2 Florida Natural Growers, 20205 US Hwy 27, Lake Wales, Florida 33853 | Director of Internal Audit | | | |
| 3 | | | | |
| 4 | | | | |
| 5 | | | | |
| 6 | | | | |

Print Editions Cannot Be Used.

212

218 of 308

JEFF BINGAMAN
KIN 3443

703 HART SENATE OFFICE BUILDING
WASHINGTON, DC 20510-3152
(202) 224-1521
IN NEW MEXICO - (505) 463-6008
TDD: (202) 224-1182
Senator: Bingaman@bingaman.senate.gov

United States Senate

September 24, 2009

The Honorable Blanche Lincoln
Chairman
Senate Agriculture, Nutrition and Forestry Committee
Washington, D.C. 20510

Dear Chairman Lincoln:

I am writing to support President Obama's nomination of Scott O'Malia to be a Commissioner on the Commodity Futures Trading Commission, and to encourage the Agriculture Committee to move quickly to approve his nomination.

Scott served on the Energy and Natural Resources Committee in 2003 before moving to the Appropriations Committee. Scott's primary responsibilities on the committee were oil and natural gas issues. He demonstrated a deep understanding of these issues and of the importance energy markets have on our economy. During his tenure on the Committee, Scott was always willing to cooperate with my staff in the development of hearings and legislation.

Since joining the Energy and Water Development Subcommittee on Appropriations, Scott has continued to work with the Energy and Natural Resources Committee to implement the 2005 and 2007 authorizing statutes. He has been willing to listen and develop constructive solutions to complex energy policy problems. A good example of his commitment to improving our nation's investment in a balanced energy strategy has been his effort to expand the role of the Department of Energy's laboratories in the areas of alternative energy and climate modeling. Scott understands the importance of diversifying our energy generation mix, and the critical role our national labs play in this effort.

In addition to Scott's work on both the authorizing and appropriations committees, I also believe his private sector experience (electric generation) provides him with the experience and knowledge that will benefit the Commodity Futures Trading Commission.

For these reasons, I fully support Scott O'Malia's nomination to serve the Commodities Futures Trading Commission.

Sincerely,



Jeff Bingaman
United States Senator

ALBUQUERQUE
(505) 348-6207

DARKENHURST
(505) 376-5200

LAS CRUCES
(575) 523-8900

ROSEMBO
(505) 622-7113

SANTA FE
(505) 588-1600

United States Senate
 SENATE OFFICE OF CLERK

September 22, 2009

The Honorable Blanche Lincoln
 Chairman
 Senate Agriculture, Nutrition and Forestry Committee
 535A Russell Building
 Washington, DC 20540

Dear Chairman Lincoln:

I am writing to support Scott O'Malia for Commissioner of the Commodity Futures Trading Commission. President Obama nominated Scott earlier this month. I encourage the Agriculture Committee to move quickly to approve this nomination so that the Commission will be fully staffed as it deliberates reforms to the financial and commodities industry.

Since becoming Chairman of the Energy and Water Subcommittee in December 2006, I have worked with Scott O'Malia. Scott has exhibited an in-depth knowledge of energy issues and has worked hard to implement policies that will transform our nation's energy sector. As an example, Scott has been a tireless advocate for improving the effectiveness of the loan guarantee program to ensure that the nation invests its resources in a balanced energy strategy and deploys low-emission technology as quickly as possible and on a scale that make a significant and lasting difference.

Scott works in a bipartisan and constructive manner, advocating strongly for his Member's position, but willing to find common ground in order to complete the work before the subcommittee. I believe his experience on both the authorizing and appropriations committees, and his role in the private sector provide him with the expertise and knowledge that will benefit the Commodity Futures Trading Commission and expand the Commission's depth on energy issues.

I appreciate your taking on this new role at the Commission. And thanks for taking a look at this nomination.

Sincerely,

 Byron Dorgan

PATTY MURRAY
WASHINGTON

COMMITTEES
APPROPRIATIONS
BUDGET
HEALTH, EDUCATION
AND PENSIONS
RULES AND ADMINISTRATION
VETERANS AFFAIRS

United States Senate
WASHINGTON, DC 20510-4704

September 29, 2009

The Honorable Blanche Lincoln
Chairman
Committee on Agriculture, Nutrition
and Forestry
Russell Senate Office Building 328A
Washington, D.C. 20510

The Honorable Saxby Chambliss
Ranking Member
Committee on Agriculture, Nutrition
and Forestry
Russell Senate Office Building 328A
Washington, D.C. 20510

Dear Chairman Lincoln and Ranking Member Chambliss:

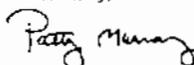
I write to express my strong support for the nomination of Scott O'Malia to be a Commissioner on the Commodity Futures Trading Commission (CFTC).

Mr. O'Malia has worked well with me and my staff as Minority Clerk to the Appropriations Committee's Energy and Water Subcommittee, of which I am a member. During his tenure on the Appropriations Committee, he served as both Majority and Minority staff. In both capacities, I found him to be straightforward and fair as he worked with me on my priorities over the past five years. I have great confidence that he would bring the same professional and forthright demeanor to the CFTC as a Commissioner.

Mr. O'Malia has legislative and private sector experience related to the energy sector that will be needed on the CFTC as it works to address financial and commodity reform. He has enjoyed good bipartisan working relationships and is someone Senators and Members of Congress should expect to work with effectively in the future if he is confirmed. I urge you to quickly and carefully consider this nomination so that the full complement of Commissioners can be in place as the CFTC undertakes its important role in addressing financial and commodity sector reform.

I am confident that Mr. O'Malia's confirmation as a Commissioner will help the CFTC address pressing regulatory needs. I hope you will give his nomination all due consideration.

Sincerely,


Patty Murray
United States Senator

112 RUSSELL SENATE OFFICE BUILDING
WASHINGTON, DC 20510-4704
(202) 224-2821

1811 L STREET AVENUE, NE
SUITE 318
BELLEVUE, WA 98004-3046
(425) 462-4950

2920 WESTHEDGE AVENUE, NW
SUITE 302
EVERETT, WA 98201-4107
(425) 253-0515

2888 JACOBSON FEDERAL BUILDING
510 2ND AVENUE
SEATTLE, WA 98104-1023
(206) 453-8345
Toll Free: (866) 481-9126

501 WEST MAIN AVENUE
SUITE 802
SPokane, WA 99201-0513
(509) 674-9519

810 PULLER
SUITE 111
TACOMA, WA 98402
(253) 572-1177

THE MURRAY CENTER
1325 OLYMPIA ROAD
VANCOUVER, WA 98661-3856
(360) 586-7797

website: <http://www.patty.gov>
4 me + 1mp + 1m + 1a + 1p + 1m + 1a
#PattyMurrayCFTCPaper

401 S. ...
...
386-415-7111



September 29, 2009

The Honorable Blanche Lincoln, Chairman
Senate Committee on Agriculture, Nutrition and Forestry
328A Senate Russell Building
Washington, DC 20510

Dear Senator Lincoln,

I am writing to urge you to support the nomination of the Honorable Harris Sherman who has been nominated for the Under Secretary of Natural Resources and the Environment. I have known Mr. Sherman for over twenty years on both a personal and professional level and can attest to his unique qualifications as a special individual, one having a thorough understanding and respect for the environment and an individual who can help guide the long term management and protection of our natural resources.

Mr. Sherman's experience in the caring management of people and his breadth of experience as a well respected public servant will lend itself well in the position that he is being nominated to fill. Mr. Sherman has the ability to manage and guide policy for our forests and to protect wildlife and water quality on the lands that he will be overseeing. In addition he is well versed in the laws governing the USFS and the unique balance that the agency faces for the multi-use of its resources.

It is interesting times that we face as we seek to better understand how to protect our natural resources for future generations. I believe that Mr. Sherman has the commitment, experience and the depth of knowledge to be a fair and generous protector of our natural resources and encourage you to support his nomination. He is a good and honest person that can seek consensus, solve problems and help establish policies that further protect our environment. We wish you well in the upcoming proceedings and hope that you will support his nomination.

Yours truly,

A handwritten signature in black ink, appearing to read "Timothy H. Beck", written over a horizontal line.

Timothy H. Beck
Executive Vice President, Planning



10/04/2009 1:51

7956747300

BRUNDAGE MOUNTAIN RESORT



October 2, 2009

The Honorable Blanche Lincoln
 Chairman
 Senate Committee on Agriculture, Nutrition & Forestry
 328A Senate Russell Building
 Washington, DC 20510

Senator Lincoln:

Brundage Mountain Resort is located on the Payette national Forest in west central Idaho. Agriculture and tourism are the largest industries in Idaho, a state rich in natural resources. We are strongly in support of appointing Harris Sherman to the position of USDA Under Secretary for Environment and Natural Resources. Mr. Sherman has the experience with the agriculture, recreation, forest industries and the states directly affected by them to be an outstanding Under Secretary for Environment and Natural Resources. He has the back ground to provide unique insight on the effect of Washington decisions on states dependent on natural resources and the knowledge to craft decisions that will benefit all stake holders.

Thank you for your consideration!

Sincerely,

Frederick P. Certano
 President/GM
 Brundage Mountain Resort
 President
 Idaho Ski Areas Association

Brundage Mountain Company • P.O. Box 1063 • McCall, Idaho 83638
 208.634.4151 • fax 208.634.2806 • 1.800.888.7544
 www.brundage.com • info@brundage.com

Hon. Blanche Lincoln
Hon. Saxby Chambliss
United States Senate

Dear Chairman Lincoln and Ranking Member Chambliss:

I write you today to voice support for the nomination of Mr. Harris Sherman to the position of Under Secretary of Agriculture for Natural Resources and Environment.

Mr. Sherman's reputation for pragmatism and earnest collaboration is well-earned. Throughout his tenure as the Executive Director of the Colorado Department of Natural Resources, he has shown a calm commitment to building consensus and honoring stakeholder processes.

On contentious issues ranging from the regulation of oil and gas development to the designation of roadless areas in Colorado's National Forests, Mr. Sherman has maintained a voice of reason and a sincere willingness to hear all sides and strive for compromise, often amidst a cacophony of opposition from the extreme areas of the ideological spectrum. While his service has been of immense value to the people of Colorado and the environment, the compromises he has crafted have not always pleased everyone. But the results are impressive.

Mr. Sherman's accomplishments include a balanced regulatory regime that, for the first time, injects environmental protection and public health as factors in the consideration of oil and gas drilling permit applications and the culmination of a locally-driven stakeholder process to designate appropriate areas in national forests as off-limits to road building.

I fully expect Mr. Sherman's professionalism, experience and acumen will serve the President and the nation well. We will be sorry to see him leave Colorado, but will take solace in the fact that his public service will continue.

Very truly yours,



Dan Grossman
Rocky Mountain Regional Director
Environmental Defense Fund



PO Box 2308 • 249 Warren Ave • Silverthorne, CO 80498 • 970-468-0295 • Fax 970-488-1208 • www.nwccog.co.us

- MEMBER JURISDICTIONS**
- City of Glenwood Springs
- City of Steamboat Springs
- Town of Carbondale
- EAGLE COUNTY**
Avon
Basalt
Eagle
Gypsum
Minturn
Red Cliff
Vail
- GRAND COUNTY**
Fraser
Granby
Grand Lake
Hot Sulphur Springs
Kremmling
Winter Park
- JACKSON COUNTY**
Walden
- PITKIN COUNTY**
Aspen
- SUMMIT COUNTY**
Breckenridge
Dillon
Frisco
Montezuma
Silverthorne

September 29, 2009

United States Senate Agriculture, Nutrition and Forestry Committee
 Senator Harkin, Chair
 Senator Chambliss, Ranking Republican Member

Dear Senators Harkin, Chambliss and Committee Members,

Northwest Colorado Council of Governments is a voluntary association of twenty-eight county and municipal governments in the High Country of Colorado. Nearly seventy percent of the ten thousand square mile region covered by the NWCCOG member jurisdictions is owned by the people of the United States and managed by a variety of federal agencies, principal of which is the USDA Forest Service. The NWCCOG Region is also the headwaters of the Colorado and North Platte River Systems, supplying domestic, agricultural and recreational water to vast areas of the Great Plains and Southwest.

In matters pertaining to the management of national forest system lands and water quality and quantity, we have worked with Harris Sherman in his position as Executive Director of the Colorado Department of Natural Resources. In our experience, we have found Director Sherman to be not only a proponent, but an active participant in collaborative conservation. He has demonstrated his ability to participate in good faith in collaborative processes with a diverse array of stakeholders. Those processes are often long, tedious, and arduous as a wide variety of opinions are explored, but they are nonetheless necessary to achieve quality and lasting decisions regarding our forest and water resources in an open, neighborly and democratic manner indicative of the Rocky Mountain West.

We consider Harris Sherman to be a good partner in the difficult job of managing public resources and encourage you to confirm him as USDA Undersecretary for Natural Resources and Environment.

Sincerely,

Gary Severson, Executive Director

NATIONAL
SKI AREAS
ASSOCIATION



September 23, 2009

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture, Nutrition & Forestry
328A Senate Russell Building
Washington, DC 20510
Fax: 202 228 2125

**Re: Harris Sherman for USDA Undersecretary
of Environment and Natural Resources**

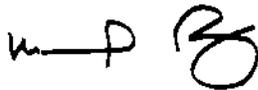
Dear Senator Lincoln:

I am writing on behalf of the National Ski Areas Association (NSAA) in support of Harris Sherman for the position of USDA Under Secretary for Environment and Natural Resources. NSAA is the trade group for ski areas across the country. Our resort members account for 95% of the skier/snowboarder visits in the United States. One hundred and thirty-four (134) member resorts operate on National Forest System lands.

Harris Sherman's entire career has been dedicated to environment and natural resources issues. As a result of his experience directing the Colorado Department of Natural Resources, he has a great appreciation for working cooperatively with stakeholders to solve problems. His advocacy experience as an attorney will serve him well in representing the Department before Congress. Harris' communication, political and people skills are unmatched in the pool of candidates that have been considered for this post. On a personal level, Harris is one of the most likeable and personable individuals you could ever meet.

Harris Sherman will be a great asset to the Secretary of Agriculture and would provide tremendous leadership for the Administration on environment and natural resources issues. Thank you for your consideration of NSAA's comments.

Best Regards,



Michael Berry
President

September 29, 2009

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture
328-A Russell
Washington, DC 20510

The Honorable Saxby Chambliss
Ranking Member
Senate Committee on Agriculture
328-A Russell
Washington, DC 20510

Dear Chairman Lincoln and Ranking Member Chambliss:

The Society of American Foresters represents 14,000 foresters, men and women who care deeply for our Nation's vast forest resources. As a professional association, we work closely with the U.S. Department of Agriculture (USDA) to implement conservation programs, state and private forest programs and manage the National Forests. We are writing you in support of the nomination of Harris Sherman to become the Undersecretary for Natural Resources and the Environment (NRE) at USDA.

The Undersecretary for NRE is a key position for overseeing the conservation programs of the Natural Resource Conservation Service (NRCS) and the U.S. Forest Service (USFS). Mr. Sherman's background in forestry, conservation and natural resource protection will serve him well to lead USDA's conservation and forestry division. We appreciate his record of success in implementing conservation strategies, finding common ground, and his commitment and passion for the wise use of natural resources, specifically his support for forest management.

We respectfully urge you to approve Mr. Sherman's nomination and thank you for your consideration.

Sincerely,



Michael T. Goergen, Jr.
Executive Vice President and CEO



September 18, 2009

Via Fax: 202.228.2125

The Honorable Blanche Lincoln
Chairman
Senate Committee on Agriculture, Nutrition & Forestry
328 A Senate Russell Building
Washington, DC 20510

Re: Confirmation of Nomination of Harris Sherman as USDA Under Secretary for Environment and Natural Resources

Chairman Blanche Lincoln:

As a long time member of the National Ski Areas Association, the Steamboat Ski & Resort Corporation is pleased to read that Harris Sherman has been nominated to be the USDA Under Secretary for Environment and Natural Resources. We congratulate Mr. Sherman on his nomination.

During his many years at Arnold & Porter, LLC, one of the top law firms in the country, Harris dealt with numerous public lands issues and always demonstrated professionalism, dedication and focus.

He has worked diligently to improve conservation of open space, wilderness areas, water supplies and forest planning, has a wealth of knowledge with extensive work in the ski industry. He has championed efforts for development of the Colorado Roadless Rule and has dedicated much of his professional career to protecting Colorado's precious natural resources. We are confident that he will serve our nation with the same regard.

We urge the Senate Agriculture Committee to confirm Harris Sherman as this nation's next Under Secretary for Environment and Natural Resources.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "C. Diamond".

Christopher S. Diamond
President and COO

DCB: Geraldine Link

I and the members of the Colorado Timber Industry Association have had a good working relationship with Harris Sherman. He has been very thoughtful and constructive on issues including Roadless Rule, bark beetle epidemics, and national forest timber sale programs. I believe Harris is well-suited and well-qualified for Under Secretary for NRE.

Jon Troxel
ix Director
Colorado Timber Industry Assn
Sent from my Verizon Wireless BlackBerry

VAIL RESORTS®

EXTRAORDINARY RESORTS • EXCEPTIONAL EXPERIENCES™

September 16, 2009

The Honorable Michael Bennet
702 Hart Senate Office Building
Washington, DC 20510

Dear Senator Bennet:

I am writing to support the nomination of Harris Sherman for USDA Under Secretary for Environment and Natural Resources. I would like to strongly encourage you as a member of the Senate Committee on Agriculture, Nutrition and Forestry to vote to confirm Mr. Sherman for this appointment. As one of the largest ski operators in the country, Vail Resorts is made up of five ski resorts in Colorado, California and Nevada, all of which operate on National Forest System lands.

In all of my dealings with Harris Sherman, I have known him to be incredibly balanced in his approach to issues and problems. He does a remarkable job of bringing competing interests to the table and creating an environment for them to work cooperatively. As you well know, he has had great success as the Director of the Colorado Department of Natural Resources doing just that, particularly spearheading the new oil and gas regulations that passed through the Colorado legislature this year.

Harris Sherman has spent his life working on environmental issues. His commitment to working to preserve and protect the natural resources and iconic landscapes that make up our beautiful country is unmatched. I strongly believe that Mr. Sherman will bring these values to USDA at a time when leadership in creating policies that protect the environment now and into the future is critical.

Harris Sherman would be a true asset and provide great leadership for the Administration. Thank you for your consideration.

Sincerely,

Rob Katz
CEO and Chairman
Vail Resorts

Robert Katz • Chief Executive Officer

Vail Resorts, Inc. • 390 Interlocken Crescent, Suite 1000 • Broomfield, CO 80021 • vailresorts.com
Direct 303 404 1801 • 303 404 6401 • rkatz@vailresorts.com

9

QUESTIONS AND ANSWERS

SEPTEMBER 30, 2009

Senator Blanche L. Lincoln

Question for Commissioners Chilton and Sommers

On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

QUESTIONS FOR AVALOS

AMS: FRESH PRODUCE PROCUREMENT FOR NUTRITION PROGRAMS

The Agricultural Marketing Service (AMS) has responsibility for purchasing the food that is distributed to schools, food banks, and other institutions through USDA's nutrition and food assistance programs. Over the years, the amount of fresh produce purchased by AMS has steadily declined to the point that fresh produce represents less than 5 percent of the total value of food purchased in any given year. Recently, AMS has begun several pilot programs to purchase fresh-cut produce for distribution to schools participating in the National School Lunch Program (NSLP). Many would like to see these programs expanded in as expeditious a manner as possible.

Can we have your assurance that, if confirmed, you will work quickly to develop and implement a plan to continue the expansion of AMS's fresh-cut produce purchases?

AMS: PROCESS VERIFIED MEAT LABEL CLAIM STANDARDS

Currently, both AMS and the Food Safety and Inspection Service (FSIS) verify claims made on meat product labels. The result can be uncertainty and confusion for consumers as to what it is they are purchasing, and hardship for farmers and ranchers using alternative methods of production.

Can we have your assurance that you will work with the yet-to-be-named Under Secretary for Food Safety to develop a clear, consistent policy between AMS and FSIS to verify package-label claims with respect to animal production?

APHIS: EMERGENCY PEST AND DISEASE SPENDING

For some time, Congress and the Office of Management and Budget (OMB) have been locked in a disagreement over how to spend emergency funds to fight plant pests. Congress has passed laws to direct the Secretary of Agriculture to use emergency funds when necessary to combat pest outbreaks, only to have OMB later block such spending. In the recent farm bill, Congress again made explicit that these funding decisions belong exclusively to USDA.

if confirmed, can the committee have your assurance that you will work with OMB to ensure that these funding decisions are based on the statutory direction provided in the farm bill?

APHIS: LACEY ACT IMPLEMENTATION

The Lacey Act is the nation's oldest wildlife protection statute. The Act has served as a key tool to combat trafficking in illegal wildlife, fish or plants. Section 8204 of the Food, Conservation and Energy Act of 2008 expands Lacey Act protections to a broader range of plants that are illegally taken with a few exceptions. Excluded from coverage are "common cultivars", except trees, and "common food crops". APHIS has been working to define these two terms for over a year. It's important that APHIS quickly define these terms to help provide clarity for many stakeholders.

Can I have your assurance that you will work with the Animal and Plant Health Inspection Service (APHIS) to provide a definition for these terms as quickly as possible?

Additional Questions for Edward M. Avalos to be Under Secretary of Agriculture for Marketing and Regulatory Programs:

The current Administration and USDA have made Global Food and Energy Security two of their top priorities for American agriculture to play a key role in. Secretary Vilsack has highlighted the role of technology in meeting those goals. Biotechnology, because it allows producers to produce more with less, is one technology that is key in my mind, especially in helping to meet the global population demand for safe food products. Would you agree?

In order for producers and consumers to realize the benefits of agricultural biotechnology, it is essential that USDA implement a timely and science-based approval process for the innovative biotech products waiting to be approved.

It is my understanding that currently the average length of time for agency decision making on petitions for regulatory approval of agricultural of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at present.

This trend is problematic and recent developments with regard to two specific crops have been brought to my attention.

Two and a half years ago, a Federal Court ruled that USDA should have conducted an Environmental Impact Statement before deregulating Roundup Ready alfalfa. Farmers lost the ability to plant biotech alfalfa until USDA completed what APHIS predicted to be a two-year EIS process.

Given the economic crisis that dairy farmers face and the importance of high-quality alfalfa to milk production, it is important USDA make this a priority. The same court just ruled that USDA needs to do an EIS for biotech sugarbeets. It would be logical to conclude more EIS reviews of biotech crops are in USDA's future.

In the near term, what is USDA going to do to complete the overdue EIS for Roundup Ready alfalfa? Is there a commitment of priority and resources to complete the sugarbeet EIS in a more timely way? And in the long-term, how will USDA ensure timely completion of future Environment Impact Studies so that the U.S. regulatory process does not go from being the gold standard of the world to a barrier for much needed innovation?

Finally, how can this Committee be helpful in assuring that USDA has and is utilizing the necessary resources to process science base approvals of ag biotech products in a timely fashion?

Senator John Barrasso, M.D.

Questions for the Record

Senate Committee on Agriculture, Nutrition and Forestry

CFTC, USDA, Farm Credit Nominations Hearing

10:00am, Wednesday, September 30, 2009

Harris D. Sherman, of Colorado, to be Under Secretary of Agriculture for Natural Resources and Environment and to be a Member of the Board of Directors of the Commodity Credit Corporation

1. In Wyoming, where more than half of the state is public land, we are keenly aware of the U.S. Forest Service responsibility for management of its lands. Currently, we face an unprecedented bark beetle infestation that threatens our forests and communities. If confirmed, how will you address the following management challenges related to this infestation?
 - a. Programmatic funding for Regions 2 and 4 of the U.S. Forest Service has historically fallen well below need. These regions have been disproportionately deprived of management resources. How will you address the funding needs for management of the bark beetle outbreak throughout Regions 2 and 4?
 - b. U.S. Forest Service local managers are facing an unprecedented forest health event. What management authorities do you believe need to be adjusted to meet the challenges posed by this infestation? Specifically, how will the Department, under your direction, address each of those needs?
 - c. Bark beetle infestation spreads beyond political boundaries. We must take a regional approach to management of our forests. Specifically, how will you promote regional action to regional management of the bark beetle infestation?

2. Our forest products industry partners are struggling in this economy. Many of the industry partners who historically helped manage federal forests are no longer in business. This increases the burden on federal agencies and weakens our local communities. If confirmed, how will you promote business friendly practices at U.S. Forest Service to sustain and regrow the American forest products industry?

3. U.S. Forest Service recently proposed spending \$2.8 million of wildland fire management funding under PL 111-5, the "American Recovery and Reinvestment Act," in Washington, D.C. Of the 5.5 million acres of wildlands nationwide, as defined by the National Interagency Fire Center, Washington, D.C. has none. There is no need for wildland fire management funding in the District of Columbia. While the kind of State and Private Forestry projects proposed for Washington, D.C. have merit, wildland fire management funding should not be diverted for this purpose. U.S. Forest Service must prioritize its limited resources to meet its basic responsibilities. Wyoming communities depend upon adequate management of U.S. Forest Service lands and we demand that the agency get its

priorities straight. If confirmed, how will you direct U.S. Forest Service to prioritize its wildland fire management budget in the future?

4. If confirmed, will you join Secretary of Interior Ken Salazar in supporting west-wide good neighbor authority, that would allow BLM and U.S. Forest Service to enter cooperative agreements with the states to implement forest health projects?
5. U.S. Forest Service renewal of grazing permits is continually backlogged. This is a detriment to public land ranchers and to the day-to-day operation of the U.S. Forest Service range management. If confirmed, specifically how will you address the permit backlog and improve the agency's handling of grazing permit renewals?

Questions from Sen. Max Baucus for nominees considered by the Committee on Agriculture on September 30, 2009

To: Mr. Harris Sherman, Nominee for Undersecretary for Natural Resources and the Environment, United States Department of Agriculture

Congratulations on your nomination to be Undersecretary for Natural Resources and the Environment for the Department of Agriculture. I am pleased that the President has chosen someone with your experience dealing with issues facing the forests, prairies and water resources of the West.

If confirmed, you will oversee programs and implement authorities that have a major impact on the economy and natural environment of my state. One authority the Forest Service has at its disposal is the ability to enter into stewardship contracts that enable it to trade logs and other goods to help carry out projects that reduce hazardous fuels, improve watersheds and other important forest management goals.

Stewardship contracting is very popular in Montana, helping form collaborative partnerships among diverse groups of forest users such as the wood products industry, the conservation community and sportsmen. Stewardship contracting also makes good economic sense for the Service. On one ranger district in my state, stewardship contracting enabled the ranger to perform nearly \$1 million of service work for which the district did not have appropriated funds.

While I am pleased that use of stewardship contracting is gradually increasing, I want the Forest Service to do much more. Since the Service was given broader contracting authority in 2003, it has completed only 34 contracts in the Northern Region. Most other regions have completed even fewer. I would like to know if you, as undersecretary, would work to substantially increase use of stewardship contracting, not only in my state, but across the nation. Does the Forest Service need any additional authorities to improve and increase the use of stewardship contracting and agreements?

Additionally, some non-profit groups have told me the Forest Service has been inflexible in determining matching requirements for stewardship agreements. The stewardship authority provides Forest Service and Bureau of Land Management personnel the same discretion in establishing matching requirements. Yet, the Forest Service requires a 20 percent match from non-profits, while the BLM requires no firm match. These non-profits can be valuable partners in stewardship projects and the Service should be more creative in evaluating their contributions. I would like to know if you will take steps to encourage non-profit participation in stewardship agreements.

To Bartholomew Chilton, Jill Sommers and Scott O'Malia, nominees for Commissioners of the Commodity Futures Trading Commission:

Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

U.S. Senator Maria Cantwell
Questions for CFTC Nominees
September 30, 2009

Mr. Chilton, O'Malia, and Ms. Sommers:

1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?
2. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?
3. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?
4. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and

index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

5. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?
6. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the "recklessness" standard instead of the current "specific intent" standard, how would this improve the Commission's ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?
7. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the "Treasury Proposal to Regulate OTC Derivatives" and "CFTC Legislative Language" as it relates to this proposal. In reviewing GMAC membership as posted on the Commission's website, it appears that the committee's membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

**Sen. Saxby Chambliss
Questions for the Record
Nomination Hearing
September 30, 2009**

Mr. Sherman

1. As I mentioned at the hearing, I have been contacted by several constituents about your nomination. They raise concerns about your approach to managing federal, state and private land. Below is a list of the concerns I have received. Please respond to these concerns.
 - Harris Sherman supports the Clinton-Babbitt Roadless rule and has worked in Colorado to revert to the Clinton-Babbitt Roadless Rule.
 - He would be a threat to oil and gas, mining, coal mining, timber, grazing, gravel extraction and recreation and much more.
 - According to residents of Colorado, Sherman used his position to extort or shake down money from oil and gas firms to fund his wildlife studies in return for his office not opposing their permits. In effect, he set up a "pay to play" approval process for oil and gas permits under the Colorado Dept. of Wildlife.
 - He rewrote important environmental documents with the assistance of environmental activist groups negating public meetings and public comment.
 - Environmental groups had special access under Harris not available to the public or other land users.
 - He set up rules that infringed on private property.
 - He set up a system whereby the CO Dept. of Wildlife could interfere with private contracts between farmers, ranchers and landowners and oil and gas and mining companies. He was able to blow up private contracts where he did not want oil and gas or mining operations to occur.
 - It is likely he will give environmental groups special control over the US Forest Service. His pattern is to feather his own nest and he would likely use the Forest Service to do that as he did in Colorado.

2. The U.S. Department of Agriculture (USDA) seems to be carefully tracking stimulus projects which are supporting the use of wood fiber for the production of biomass energy. However, despite receiving more than \$500 million for hazardous fuels reduction projects, it appears that almost none of these projects will produce wood fiber that can be used by the traditional sawmill and paper mill industries. Please tell me how many ARRA projects have produced merchantable wood fiber? How much volume in board feet or cubic feet did those produce? Please tell me whether ARRA funds have been used to pay for the non-merchantable component of stewardship contracts, allowing the commercial component to go forward in down timber markets?

3. Recently, Secretary Vilsack announced his vision for the role of USDA in managing public and private forests. His "all landscapes" approach suggests that USDA will take an active role in matters affecting private forests, including their participation in climate change and energy policies and their role in addressing environmental services, like clean

water and air and providing wildlife habitat. Working forests are a significant part of the jurisdiction of this committee, and we want to make sure that any policies affecting working forests are developed with the full participation of private forest owners and this committee. Will you fully involve private forest owners in the development of USDA policies on working forests? Will you fully involve this committee in any policies USDA develops on working forests? Will you commit to working with the committee to explore policy opportunities together that will promote the benefits of working forests?

Mr. Avalos

1. Agricultural biotechnology is a key priority of mine. It is important that farmers across the country have access to the best technology available. Of course, we must ensure that the products are safe and the regulatory process is based on sound science. It is this need for a timely and science-based approval that concerns me. As noted by Chairman Lincoln at the hearing, the average length of time for agency decision making on petitions for regulatory approval of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at the present time.

Will you develop a plan to get those products deemed safe to market more quickly? Will you provide a report to the Committee within 90 days regarding the cause of the delays and how USDA plans to ensure the Department issues scientifically based regulatory decisions in a timely manner?

2. Mr. Avalos, as you know, if confirmed you will be overseeing the APHIS Biotechnology Regulatory Services. Now pending within the USDA is the publication of draft Environmental Impact Statement to determine whether Round-Up Ready Alfalfa (RRA) can be deregulated. The completion of this EIS has taken far longer than anyone anticipated and is now jeopardizing the ability of farmers to have RRA available for the 2010 planting season. Would you commit to reviewing this problem and reporting to the committee when the EIS will be finalized and published in the *Federal Register*?
3. Over the last 15 years, business practices in the livestock industry have changed dramatically. Producers and meat companies have largely turned to alternative marketing arrangements, rather than the traditional spot market for livestock. The Grain Inspection, Packers & Stockyards Administration released a Congressionally-mandated study in 2007 of marketing issues and packer ownership of livestock. This exhaustive study concluded that alternative livestock marketing agreements benefit both producers and industry. Industry concentration is also a concern for some, but the 2008 Packers & Stockyards Administration Annual Report indicates that concentration has largely led to lower prices for consumers and better income margins for producers and processors. This Committee also held a hearing on these issues in 2007. Despite previous extensive study of this issue, USDA and the Department of Justice have announced a series of Public Workshops next year to address competition and concentration issues in the agriculture sector. Given your responsibilities will include overseeing GIPSA, do you feel there are problems in the industry that GIPSA is not policing? Will you provide the Committee with a detailed description of USDA's plans for any changes in policy or operations within GIPSA or in its relationship with the Department of Justice?

4. The Animal & Plant Health Inspection Service currently has a rule pending that would allow for importation of cooked pork skins from regions affected with swine diseases. This rule was proposed after a risk assessment concluded that cooking methods were sufficient to inactivate any pathogens of concern. APHIS for decades has protected U.S. agriculture by ensuring that imports from affected countries are processed in a manner that eliminates any potential harm. APHIS issued a proposed rule on July 2, 2008, and the agency's examination of this matter dates back to 2003. This rule received very few public comments, and does not appear to have raised many issues. Will you provide an update to the Committee regarding the status of the proposed regulation and when the Department plans to release a final rule?

5. As Under Secretary, you will oversee the National Organic Program. Secretary Vilsack has expressed a new commitment to the program and to help producers who choose to raise and market organic crops and livestock. However, organic production and certification can be a costly process. Congress has addressed this with the Organic Certification Cost-Share Program, and I applaud USDA for releasing the 2009 program this week. In 2008, USDA revised its accreditation procedures for certifying agents in the National Organic Program. This revision has raised concerns with some certifying agents that their costs could increase markedly. Many of these certifying agents are non-profit and public entities, and serve smaller local organic producers who cannot afford high administrative costs. Will you work with the new leadership of the National Organic Program to develop a plan to lower administrative costs and the burden on small producers and report to the Committee on your progress?

Senator Thad Cochran
Nomination Hearing Questions
September 30, 2009

Mr. Avalos, the Department of Agriculture is working to finalize a rule allowing for the importation of cooked pork skins subject to certain processes to protect public health. When do you expect the Department to finalize this important rule? Also, do you believe the Department should follow different rules for beef and cooked pork skins when approving countries for imports? I ask that you review this issue and work to finalize the rule.

Senator Charles E. Grassley
Nominations Hearing Questions
September 30, 2009 10:00am

CFTC

Bartholomew Chilton, Commissioner of the Commodity Futures Trading Commission
Jill Sommers, Commissioner of the Commodity Futures Trading Commission
Scott O'Malia, Commissioner of the Commodity Futures Trading Commission

- 1) This question is just for Ms. Sommers and Mr. O'Malia. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?
- 2) In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?

USDA

Edward M. Avalos, Under Secretary of Agriculture for Marketing and Regulatory Programs

- 1) Specifically related to Packers and Stockyards Program, how do you intend to make sure there is greater enforcement of the competition provisions of the P&S Act?
- 2) One of the most critical jobs within the MRP mission area is the biotechnology approval process at the Animal Plant Health Inspection Service. The U.S. is the leader in developing and using biotechnology and it should remain that way. However, over the last decade the time to deregulate these new products has slowed considerably. Will you make deregulation a priority within your mission area and can you assure me that these decisions continue to be based on science?

Farm Credit

Kenneth Albert Spearman, Member of the Farm Credit Administration Board

- 1) As you know many in the agriculture sector and in particular livestock producers are struggling to stay afloat. On top of the tough economic times they are facing, now it seems as if credit is also drying up. Many banks have looked at their agricultural portfolio as a liability and that in turn has added another burden to our producers. What

do you see as the role of the Farm Credit Administration in working with the farm credit system member banks to help these producers through this economically uncertain time?

QUESTIONS SUBMITTED BY SENATOR HARKIN TO HARRIS SHERMAN

1. The Food, Conservation, and Energy Act of 2008 (FCEA) reflects carefully balanced and integrated compromises. Among the most important decisions by Congress was the agreement to include some \$4 billion in additional funding for conservation programs over 10 years above budget baseline levels. The policies enacted and funded in the legislation are being effectively used, for example, in the recently-announced Mississippi River Basin Initiative, which makes extensive use of funding from the Environmental Quality Incentives Program (EQIP) and authority from the Cooperative Conservation Partnership Initiative.

Do you agree that in light of the significant demands and need for conservation on agricultural land it would be unwise to cut back on the funding committed to conservation in the FCEA?

2. In recent audits by the Department of Agriculture Office of Inspector General of the Wetlands Reserve Program and the Conservation Security Program the OIG identified failure to ensure compliance with the program requirements. This problem traces back, in my view, to insufficient funding being allocated for Natural Resources Conservation Service technical assistance personnel and activities so that conservationists can carry out conservation programs, including necessary compliance checks. For instance, the number of acres enrolled in the Wetlands Reserve program has continued to increase, and therefore the cost of monitoring and enforcing WRP easements has continued to rise, but the technical assistance support funding allocated for the program has stayed relatively flat at around 5 percent of total WRP funding. Currently, WRP technical assistance cost for monitoring and enforcement are an estimated \$12 an acre, but allocated funding for these activities are only around \$6 an acre.

How will you ensure that sufficient funding is allocated to NRCS technical assistance personnel and activities so that conservation programs can be carried out and delivered to farmers and ranchers properly, and so that NRCS can fulfill its core responsibility to enforce the statutory regulatory requirements of programs?

QUESTIONS SUBMITTED BY SENATOR HARKIN TO EDWARD AVALOS

1. In March 2006, the Government Accountability Office issued a report laying out continuing problems with the Grain Inspection and Packers and Stockyards Administration's enforcement of the Packers and Stockyards Act and evaluating steps taken to respond to recommendations in an earlier GAO report from 2000. In particular, the report disclosed that the agency was artificially inflating its own records on taking enforcement actions against unfair trade practices, for example, by directing employees to categorize taking a phone call complaint from the public as opening an investigation, even if no further action were ever taken.

If you are confirmed as Under Secretary, will you meet with GIPSA officials having responsibility for enforcing the Packers and Stockyards Act, go over the steps have been taken to address the matters raised in the 2006 GAO report, and report back to this Committee and to me regarding your findings and your plan for remedying shortcomings in enforcement and ensuring that reforms in GIPSA's performance are not allowed to lapse?

2. There are indications that, due to high demand, the Department is more actively integrating issues and concerns relating to organic agriculture into the activities of the various agencies within USDA. A number of agencies have staff working on various aspects of organic agriculture and trade, including the recent announcement of organic equivalency standards with the government of Canada.

What can we expect to see from AMS, and from the Marketing and Regulatory Programs branch more generally, involving interagency and interdepartmental coordination to ensure that issues of concern related to organic agriculture and trade are addressed systematically and comprehensively throughout the federal government?

2. The Food, Conservation, and Energy Act of 2008 (the farm bill), includes \$22 million in mandatory funding over the next five years for cost-share payments for producers to help offset the cost of organic certification fees. This was a major increase over the \$5 million provided for this program in the Food Security and Rural Investment Act of 2002. Many producers contacted me to indicate their frustration with how slowly the Department moved in getting this funding out to organic farmers in the period following passage of the 2002 bill. Such delays should not be repeated in implementing the 2008 farm bill.

Can we have your assurance that you will work closely with the leadership of the National Organic Program so that cost-share funding is distributed in a timely fashion to producers?

3. In 2007, USDA solicited public comments through the Federal Register to gather recommendations as to whether the Department should proceed to develop a national marketing agreement for leafy green vegetables. USDA received over 1500 public comments, including many from smaller-scale and organic producers who were concerned about the negative impacts that such an agreement would have on their farm operations. Currently, the Agricultural Marketing Service is conducting hearing sessions throughout the United States to continue

gathering public comments on whether to develop such a marketing agreement. At the hearing session conducted in Monterey, California, testimony from members of the organic and small-scale farming community reiterated the concerns expressed during the 2007 public comment period.

Will you commit to monitor closely the results of the hearing sessions and appropriately consider and evaluate the impact that a national marketing order may have on smaller and organic producers of leafy green vegetables?

QUESTION SUBMITTED BY SENATOR HARKIN TO KENNETH SPEARMAN

Mr. Spearman, you serve as an outside board member for the AgFirst Farm Credit Bank, and this experience clearly provides you with valuable background and knowledge for serving on the board of the Farm Credit Administration (FCA). AgFirst is one of the institutions of the Farm Credit System (FCS), all of which you will be tasked with overseeing as a member of the FCA Board. To be sure, you have pledged that you will if confirmed resign from the AgFirst board and comply with the applicable conflict of interest and ethics requirements.

As a regulator you will be tasked with ensuring the safety and soundness of the FCS and also ensuring that lending by FCS institutions complies with the statutory objectives, requirements, and limitations of the Farm Credit Act of 1971, as amended. The recent turmoil in the global financial system obviously underscores the crucial importance of enforcing prudent safety and soundness standards. At the same time, as a board member of the FCA, you will have a responsibility to help facilitate FCS institutions in making affordable credit available to borrowers who are eligible under the Act.

In the light of your previous position on the board of a FCS institution, please describe carefully the approach you will take and any specific steps involved to make sure that in your new position as a member of the board of the FCA you will be truly objective, even-handed, and free of pre-determined conclusions in handling the various questions that will come before you.

Questions for Bartholomew Chilton, of Maryland, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Jill Sommers, of Kansas, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. In a recent speech and in your testimony, you noted that the CFTC has to prove that someone "specifically intended" to manipulate prices. As a former prosecutor, I know chasing criminals isn't easy, but this standard would seem to make it even more difficult to go after criminals. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Scott O'Malia, of Michigan, to be a Commissioner of the Commodity Futures Trading Commission

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?
2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Questions for Edward M. Avalos to be Under Secretary of Agriculture for Marketing and Regulatory Programs and to be a Member of the Board of Directors of the Commodity Credit Corporation

1. Mr. Avalos, the Animal and Plant Health Inspection Services announced an increase in the user fees for agricultural quarantine and inspection (AQI) services on September 28, 2009 (Monday). The fee is scheduled to take effect on October 1, 2009 (Thursday). USDA has indicated this rapid (three-day) phase-in is required because fee collections have been down and layoffs of experienced employees would be necessary if the new fee were not adopted. I have heard from airlines in my state that the time and work required to change computer systems to accommodate this rapid phase-in of a new fee is not

sufficient. **As Under Secretary, what would you do to resurrect this situation or avoid this situation in the first place?**

2. Mr. Avalos, now pending within the USDA is the publication of a draft environmental impact statement to determine whether Round-Up Ready Alfalfa can be deregulated. Are you familiar with this issue and do you support biotechnology as a means of improving the productivity of the agriculture sector? Are you aware of the USDA's timeline for publishing this draft environmental impact statement and, if confirmed, would you provide that information to the committee?

Senator Pat Roberts
Committee on Agriculture, Nutrition and Forestry
Questions for the Record
September 30, 2009

Questions for Commissioners Sommers, Chilton and Mr. O'Malia:

1. What is your definition of "systemic risk?" Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a "systemic risk" as some are suggesting?
2. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

Question for Mr. Avalos:

Congress took action in the 2008 Farm Bill to reform certain aspects of the livestock industry, particularly in regards to contracts and the enforcement of the Packers and Stockyards Act. The agreements reached in the conference report were heavily scrutinized and exhaustively debated. All sides made concessions and the end result was a bill that passed by historic margins. I understand some would like the administration to ignore these agreements and implement measures that Congress either specifically voted down or chose not to include in the Farm Bill. Can you assure me that your mission area will follow the will of Congress by honoring the commitments made in the 2008 Farm Bill?

**Senator Stabenow – Questions for the Record for Nominees
October 1, 2009**

For Edward Avalos:

1. According to the Agriculture Appropriations bill that is working its way through the legislative process, the Appropriations Committee expresses its concern about the ever-increasing number of non-native plant pests and diseases discovered in the US. In this report language, the Committee urges APHIS to address the issue and undertake extremely careful review of requests for importation from growing regions that are home to pests and diseases that do not currently exist in the U.S., so as not to add to the current pest and disease crisis. In Michigan, pests and diseases are a huge obstacle for agriculture and threaten the viability of the industry. As Under Secretary of Marketing and Regulatory Affairs, what would you do to ensure that USDA is preventing new pests and diseases from entering the country due to agricultural importation? Are you willing to work with the Senate to prevent this ever-growing problem?
2. The current AMS commodity purchase programs face many implementation challenges. Additionally, commodities that are harvested in mid to late summer often have a disadvantage for government purchase within the current system. How do you plan to improve AMS acquisition of commodities to help deal with surpluses at times when food banks are short?

For Harris Sherman:

1. What is your understanding of the authority given to USDA by section 1245 of the Farm Bill, and how do you foresee this authority being carried out over the next several years?
2. As Congress continues to debate climate legislation, what can USDA be doing now to develop methodologies and standards for GHG emission reductions in agricultural and forestry offset projects?
3. The President has committed to and Congress is ready to pass over \$400 million for Great Lakes Restoration projects. This funding will build upon the work that many Great Lakes stakeholders have been working to develop for over 5 years. Given that your position with USDA would oversee some of the largest federal conservation programs, how can USDA play a more vital role in Great Lakes restoration process?
4. Should you be confirmed, how can USDA better collaborate with EPA to ensure land management programs are more successful in the future?

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Edward Avalos
September 30, 2009

Senator Blanche Lincoln

1) **Question:**

AMS: FRESH PRODUCE PROCUREMENT FOR NUTRITION PROGRAMS

The Agricultural Marketing Service (AMS) has responsibility for purchasing the food that is distributed to schools, food banks, and other institutions through USDA's nutrition and food assistance programs. Over the years, the amount of fresh produce purchased by AMS has steadily declined to the point that fresh produce represents less than 5 percent of the total value of food purchased in any given year. Recently, AMS has begun several pilot programs to purchase fresh-cut produce for distribution to schools participating in the National School Lunch Program (NSLP). Many would like to see these programs expanded in as expeditious a manner as possible.

Can we have your assurance that, if confirmed, you will work quickly to develop and implement a plan to continue the expansion of AMS's fresh-cut produce purchases?

Response:

Children having access to more fruits and vegetables in the National School Lunch program is very important for encouraging a lifetime of healthy eating. If confirmed as Under Secretary, I would want to conduct a top to bottom review of how AMS purchases food products for the National School Lunch program and figure out best strategies for increasing fruit and vegetable purchases. I would look forward to an opportunity to develop a plan and work with you to share views on this important topic.

2) **Question:**

AMS: PROCESS VERIFIED MEAT LABEL CLAIM STANDARDS

Currently, both AMS and the Food Safety and Inspection Service (FSIS) verify claims made on meat product labels. The result can be uncertainty and confusion for consumers as to what it is they are purchasing, and hardship for farmers and ranchers using alternative methods of production.

Can we have your assurance that you will work with the yet-to-be-named Under Secretary for Food Safety to develop a clear, consistent policy between AMS and FSIS to verify package-label claims with respect to animal production?

Response:

Yes. I know producers are looking for new marketing claims that can add value to their products, but also realize that such claims only have value if they can be verified. My understanding is that FSIS is required to ensure all claims associated with federally inspected meat, poultry and egg products are truthful. If confirmed, I will place a priority on having AMS assist FSIS using AMS' independently verified production activities. I look forward to working with FSIS to provide improved coordination on this issue.

3) Question:

APHIS: EMERGENCY PEST AND DISEASE SPENDING

For some time, Congress and the Office of Management and Budget (OMB) have been locked in a disagreement over how to spend emergency funds to fight plant pests. Congress has passed laws to direct the Secretary of Agriculture to use emergency funds when necessary to combat pest outbreaks, only to have OMB later block such spending. In the recent farm bill, Congress again made explicit that these funding decisions belong exclusively to USDA.

If confirmed, can the committee have your assurance that you will work with OMB to ensure that these funding decisions are based on the statutory direction provided in the farm bill?

Response:

I am familiar with this issue, and if given the opportunity to join the team at USDA, I will work to ensure that any future emergency funding requests to fight plant pests are well-justified. I will also work to ensure an open dialogue between the Department and OMB, so that OMB understands the Department's reasoning for making any emergency funding decisions in safeguarding American agriculture.

4) Question:

APHIS: LACEY ACT IMPLEMENTATION

The Lacey Act is the nation's oldest wildlife protection statute. The Act has served as a key tool to combat trafficking in illegal wildlife, fish or plants. Section 8204 of the Food, Conservation and Energy Act of 2008 expands Lacey Act protections to a

broader range of plants that are illegally taken with a few exceptions. Excluded from coverage are "common cultivars", except trees, and "common food crops". APHIS has been working to define these two terms for over a year. It's important that APHIS quickly define these terms to help provide clarity for many stakeholders.

Can I have your assurance that you will work with the Animal and Plant Health Inspection Service (APHIS) to provide a definition for these terms as quickly as possible?

Response:

This is a new issue for me. While I have not been briefed by the USDA experts on this issue in great detail, I can commit to you that, if confirmed, I will work with the appropriate officials at USDA to gain a full understanding and appraisal of this issue. Certainly, implementing these new provisions and defining appropriate requirements is important. If confirmed, I will ensure that APHIS communicates with stakeholders and makes defining the terms you mention a priority to help bring resolution to this issue as soon as possible.

5) Question:

The current Administration and USDA have made Global Food and Energy Security two of their top priorities for American agriculture to play a key role in. Secretary Vilsack has highlighted the role of technology in meeting those goals. Biotechnology, because it allows producers to produce more with less, is one technology that is key in my mind, especially in helping to meet the global population demand for safe food products. Would you agree?

In order for producers and consumers to realize the benefits of agricultural biotechnology, it is essential that USDA implement a timely and science-based approval process for the innovative biotech products waiting to be approved.

It is my understanding that currently the average length of time for agency decision making on petitions for regulatory approval of agricultural of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at present.

This trend is problematic and recent developments with regard to two specific crops have been brought to my attention.

Two and a half years ago, a Federal Court ruled that USDA should have conducted an Environmental Impact Statement before deregulating Roundup Ready alfalfa. Farmers lost the ability to plant biotech alfalfa until USDA completed what APHIS predicted to be a two-year EIS process.

Given the economic crisis that dairy farmers face and the importance of high-quality alfalfa to milk production, it is important USDA make this a priority. The same court just ruled that USDA needs to do an EIS for biotech sugarbeets. It would be logical to conclude more EIS reviews of biotech crops are in USDA's future.

In the near term, what is USDA going to do to complete the overdue EIS for Roundup Ready alfalfa? Is there a commitment of priority and resources to complete the sugarbeet EIS in a more timely way? And in the long-term, how will USDA ensure timely completion of future Environment Impact Studies so that the U.S. regulatory process does not go from being the gold standard of the world to a barrier for much needed innovation?

Finally, how can this Committee be helpful in assuring that USDA has and is utilizing the necessary resources to process science base approvals of ag biotech products in a timely fashion?

Response:

I agree that the advances in plant biotechnology over the past several years have brought significant benefits to producers and our food security. Drought resistant varieties and yield-enhancing traits have the potential to significantly increase our production of food, feed, fiber, and fuel.

I appreciate your concern about the length of time it currently takes USDA to make a determination on petitions for biotechnology products. With advances in technology, however, comes increased responsibility by USDA to ensure sound decision-making with regard to field testing and deregulating the products of biotechnology. I understand that there is a regulatory framework in place for a reason, to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically robust documents. I also understand that it takes significant resources and time to comply with environmental regulations like the National Environmental Protection Act (NEPA). I assure you that if confirmed, I will examine USDA's regulatory approval process for biotechnology products, particularly the length of time to approve those products, and where and when possible, examine ways to address this issue.

The two court rulings on Roundup Ready alfalfa and sugar beets are also concerning to me, especially because they inject uncertainty into farmers' operations. If confirmed, I look forward to being briefed on these issues and working with the Committee to address the concerns you have raised.

Senator Saxby Chambliss

1) Question:

Agricultural biotechnology is a key priority of mine. It is important that farmers across the country have access to the best technology available. Of course, we must ensure that the products are safe and the regulatory process is based on sound science. It is this need for a timely and science-based approval that concerns me. As noted by Chairman Lincoln at the hearing, the average length of time for agency decision making on petitions for regulatory approval of agricultural biotech products has steadily increased from approximately 150 days in 1996 to almost 700 days at the present time.

Will you develop a plan to get those products deemed safe to market more quickly? Will you provide a report to the Committee within 90 days regarding the cause of the delays and how USDA plans to ensure the Department issues scientifically based regulatory decisions in a timely manner?

Response:

This is an issue that is important to me and it is important to the USDA. Advances in plant biotechnology over the past several years have brought significant benefits to producers and our food security. Drought resistant varieties and yield enhancing traits have the potential to significantly increase our production of food, feed, fiber, and fuel. If confirmed, I plan to examine USDA's regulatory approval process for biotechnology products, determine why the length of time to approve those products that are deemed safe is increasing, and examine ways to address this issue. I would be pleased to report my findings to the Committee, as requested.

2) Question:

Mr. Avalos, as you know, if confirmed you will be overseeing the APHIS Biotechnology Regulatory Services. Now pending within the USDA is the publication of draft Environmental Impact Statement to determine whether Round-Up Ready Alfalfa (RRA) can be deregulated. The completion of this EIS has taken far longer than anyone anticipated and is now jeopardizing the ability of farmers to have RRA available for the 2010 planting season. Would you commit to reviewing this problem and reporting to the committee when the EIS will be finalized and published in the *Federal Register*?

Response:

I appreciate your concern about the timeline for determining whether RRA can be deregulated. At the same time, I understand that there is a regulatory framework in

place to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically robust documents. I also understand that it takes significant resources to comply with environmental regulations like the National Environmental Protection Act (NEPA). If confirmed, I look forward to giving this matter my attention and reporting to the Committee my findings.

3) **Question:**

Over the last 15 years, business practices in the livestock industry have changed dramatically. Producers and meat companies have largely turned to alternative marketing arrangements, rather than the traditional spot market for livestock. The Grain Inspection, Packers & Stockyards Administration released a Congressionally-mandated study in 2007 of marketing issues and packer ownership of livestock. This exhaustive study concluded that alternative livestock marketing agreements benefit both producers and industry. Industry concentration is also a concern for some, but the 2008 Packers & Stockyards Administration Annual Report indicates that concentration has largely led to lower prices for consumers and better income margins for producers and processors. This Committee also held a hearing on these issues in 2007. Despite previous extensive study of this issue, USDA and the Department of Justice have announced a series of Public Workshops next year to address competition and concentration issues in the agriculture sector. Given your responsibilities will include overseeing GIPSA, do you feel there are problems in the industry that GIPSA is not policing? Will you provide the Committee with a detailed description of USDA's plans for any changes in policy or operations within GIPSA or in its relationship with the Department of Justice?

Response:

A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace.

I understand that changes made to the Packers and Stockyards Act in the 2008 Farm Bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. If confirmed, I will work to move these rules along as quickly as possible and will keep you updated on this process.

I am also aware of the proposed joint workshops next year by USDA and the Department of Justice. Although I am not aware of any specific outcomes of these workshops at this time, I do think they will provide a valuable dialogue with

producers, consumers, retailers, packers and others in the industry on issues relating to competition and concentration in the marketplace.

4) Question:

The Animal & Plant Health Inspection Service currently has a rule pending that would allow for importation of cooked pork skins from regions affected with swine diseases. This rule was proposed after a risk assessment concluded that cooking methods were sufficient to inactivate any pathogens of concern. APHIS for decades has protected U.S. agriculture by ensuring that imports from affected countries are processed in a manner that eliminates any potential harm. APHIS issued a proposed rule on July 2, 2008, and the agency's examination of this matter dates back to 2003. This rule received very few public comments, and does not appear to have raised many issues. Will you provide an update to the Committee regarding the status of the proposed regulation and when the Department plans to release a final rule?

Response:

Although I do not know when the Department plans to finalize the rule on cooked pork skins, if confirmed, I will certainly look into this upon my arrival at USDA and see where the rule is in the process and work to move it along. I understand that the Department may receive many requests in any given year for different types of animal products to be let into the country, and that these products can be treated or handled in a variety of ways to mitigate potential disease risks. If confirmed, I would like to have an opportunity to assess and review the process that is used for prioritizing these types of commodity import requests and determine if changes should be recommended.

5) Question:

As Under Secretary, you will oversee the National Organic Program. Secretary Vilsack has expressed a new commitment to the program and to help producers who choose to raise and market organic crops and livestock. However, organic production and certification can be a costly process. Congress has addressed this with the Organic Certification Cost-Share Program, and I applaud USDA for releasing the 2009 program this week. In 2008, USDA revised its accreditation procedures for certifying agents in the National Organic Program. This revision has raised concerns with some certifying agents that their costs could increase markedly. Many of these certifying agents are non-profit and public entities, and serve smaller local organic producers who cannot afford high administrative costs. Will you work with the new leadership of the National Organic Program to develop a plan to lower administrative costs and the burden on small producers and report to the Committee on your progress?

Response:

Yes. Given my experiences in New Mexico and the shared experiences of the people I have worked with in that state, I can understand the concerns you raise regarding costs and its impacts on the bottom line. If confirmed, I would like to review how these costs are administered and develop strategies that could lower the overall cost. As a prospective leader and member of the USDA Subcabinet, I believe that through dialogue and thorough listening that even better solutions can be found. For example, there may be new ideas that have yet to be explored. I would be happy to report my progress to you.

Senator Tom Harkin

1) **Question:**

Question one In March 2006, the Government Accountability Office issued a report laying out continuing problems with the Grain Inspection and Packers and Stockyards Administration's enforcement of the Packers and Stockyards Act and evaluating steps taken to respond to recommendations in an earlier GAO report from 2000. In particular, the report disclosed that the agency was artificially inflating its own records on taking enforcement actions against unfair trade practices, for example, by directing employees to categorize taking a phone call complaint from the public as opening an investigation, even if no further action were ever taken.

If you are confirmed as Under Secretary, will you meet with GIPSA officials having responsibility for enforcing the Packers and Stockyards Act, go over the steps have been taken to address the matters raised in the 2006 GAO report, and report back to this Committee and to me regarding your findings and your plan for remedying shortcomings in enforcement and ensuring that reforms in GIPSA's performance are not allowed to lapse?

Response:

Yes. A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace. I will also review the audits conducted by both GAO and USDA's Office of Inspector General to ensure the recommendations have been properly implemented. I will report to you and the Committee GIPSA's

progress in improving its enforcement activities as outlined by both GAO and Office of Inspector General.

I am aware of the changes made to the Packers and Stockyards Act in the 2008 farm bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. I will work to move these rules along as quickly as possible and will keep you updated on this process as well.

2) Question:

There are indications that, due to high demand, the Department is more actively integrating issues and concerns relating to organic agriculture into the activities of the various agencies within USDA. A number of agencies have staff working on various aspects of organic agriculture and trade, including the recent announcement of organic equivalency standards with the government of Canada.

What can we expect to see from AMS, and from the Marketing and Regulatory Programs branch more generally, involving interagency and interdepartmental coordination to ensure that issues of concern related to organic agriculture and trade are addressed systematically and comprehensively throughout the federal government?

Response:

From my perspective, the 2008 Farm Bill provided needed resources and new provisions to carry out critical activities to support organic agriculture. I am committed to ensuring there is a structured process to coordinate activities within the Department on organic agriculture to make the most of these critical investments. I know the Department has already taken a number of steps to build a more cohesive structure for coordinating organic activities, and I want to help further facilitate those actions. If confirmed, I look forward to working with you on these issues in the future and value your input for helping identify new ways to strengthen organic agriculture issues at the Department.

3) Question:

The Food, Conservation, and Energy Act of 2008 (the 2008 Farm Bill), includes \$22 million in mandatory funding over the next five years for cost-share payments for producers to help offset the cost of organic certification fees. This was a major increase over the \$5 million provided for this program in the Food Security and Rural Investment Act of 2002. Many producers contacted me to indicate their frustration with how slowly the Department moved in getting this funding out to organic farmers

in the period following passage of the 2002 bill. Such delays should not be repeated in implementing the 2008 farm bill.

Can we have your assurance that you will work closely with the leadership of the National Organic Program so that cost-share funding is distributed in a timely fashion to producers?

Response:

From firsthand experiences in my home state of New Mexico, I can appreciate frustration people have when it is perceived the government is not moving quickly enough. I also know how important this program is for organic producers and handlers. As Under Secretary, I will review the process that is used in getting these funds out the door to ensure it is as expedient and efficient as possible for funds allocated from the 2008 farm bill.

It is also my understanding that funding for fiscal year 2010 was announced on September 30 so funds should be available to producers and handlers soon. If confirmed, I welcome the chance to dig deeper into this issue and help facilitate solutions that work for everyone.

4) Question:

In 2007, USDA solicited public comments through the Federal Register to gather recommendations as to whether the Department should proceed to develop a national marketing agreement for leafy green vegetables. USDA received over 1500 public comments, including many from smaller-scale and organic producers who were concerned about the negative impacts that such an agreement would have on their farm operations. Currently, the Agricultural Marketing Service is conducting hearing sessions throughout the United States to continue gathering public comments on whether to develop such a marketing agreement. At the hearing session conducted in Monterey, California, testimony from members of the organic and small-scale farming community reiterated the concerns expressed during the 2007 public comment period.

Will you commit to monitor closely the results of the hearing sessions and appropriately consider and evaluate the impact that a national marketing order may have on smaller and organic producers of leafy green vegetables?

Response:

Yes. If confirmed, I will monitor how the hearings are going and will carefully review the results as well with particular attention to any potential impact of an agreement on small and organic producers.

Senator Debbie Stabenow

1) **Question:**

According to the Agriculture Appropriations bill that is working its way through the legislative process, the Appropriations Committee expresses its concern about the ever-increasing number of non-native plant pests and diseases discovered in the US. In this report language, the Committee urges APHIS to address the issue and undertake extremely careful review of requests for importation from growing regions that are home to pests and diseases that do not currently exist in the U.S., so as not to add to the current pest and disease crisis. In Michigan, pests and diseases are a huge obstacle for agriculture and threaten the viability of the industry. As Under Secretary of Marketing and Regulatory Affairs, what would you do to ensure that USDA is preventing new pests and diseases from entering the country due to agricultural importation? Are you willing to work with the Senate to prevent this ever-growing problem?

Response:

Invasive pests are one of the greatest threats to agriculture and our environment today and I appreciate that we share the same concern. To address these threats, the United States needs a comprehensive approach. We must use the best and most up-to-date science to evaluate all potential risk and make informed decisions about whether to allow the entry of commodities from specific regions of the world. The approach also needs to involve stringent port-of-entry inspections, coordinated domestic surveillance efforts, and increased public awareness. If confirmed, I will urge vigilance at home and abroad and enhanced coordination with all of those involved in federal, state, local, international, and non-governmental organizations. I would like to have an opportunity to work further with you on this.

2) **Question:**

The current AMS commodity purchase programs face many implementation challenges. Additionally, commodities that are harvested in mid to late summer often have a disadvantage for government purchase within the current system. How do you plan to improve AMS acquisition of commodities to help deal with surpluses at times when food banks are short?

Response:

My understanding is that there are reduced funding levels for surplus purchases. I also know that many sectors in agriculture have faced severe economic trying times and are in need of support such as through surplus removals. If confirmed, I will work with AMS to develop a purchasing plan that addresses both the economic condition of the market and the needs of recipients.

Senator Amy Klobuchar

1) **Question:**

Mr. Avalos, the Animal and Plant Health Inspection Services announced an increase in the user fees for agricultural quarantine and inspection (AQI) services on September 28, 2009 (Monday). The fee is scheduled to take effect on October 1, 2009 (Thursday). USDA has indicated this rapid (three-day) phase-in is required because fee collections have been down and layoffs of experienced employees would be necessary if the new fee were not adopted. I have heard from airlines in my state that the time and work required to change computer systems to accommodate this rapid phase-in of a new fee is not sufficient. **As Under Secretary, what would you do to resurrect this situation or avoid this situation in the first place?**

Response:

I certainly appreciate the airline industry's concerns about the timeframe for implementation, and understand that APHIS has extended the implementation date by 30 days, to November 1, to provide the industry with additional time. If I am confirmed, I assure you that I will place a premium on timely and comprehensive communications and will work to ensure that my mission area provides as much notice as possible to stakeholders before implementing any future regulatory changes.

2) **Question:**

Mr. Avalos, now pending within the USDA is the publication of a draft environmental impact statement to determine whether Round-Up Ready Alfalfa can be deregulated. Are you familiar with this issue and do you support biotechnology as a means of improving the productivity of the agriculture sector? Are you aware of the USDA's timeline for publishing this draft environmental impact statement and, if confirmed, would you provide that information to the committee?

Response:

I currently do not know when the draft environmental impact statement will be published. I do, however, look forward to being briefed on it and updating the Committee accordingly. I understand that there is a regulatory framework in place to ensure that these types of products are being introduced into the marketplace in an orderly and safe fashion. I believe that environmental impact statements should be very thorough and scientifically grounded. I also understand that it takes significant resources to comply with environmental regulations like the National Environmental Protection Act (NEPA).

Senator Pat Roberts

1) **Question:**

Congress took action in the 2008 Farm Bill to reform certain aspects of the livestock industry, particularly in regards to contracts and the enforcement of the Packers and Stockyards Act. The agreements reached in the conference report were heavily scrutinized and exhaustively debated. All sides made concessions and the end result was a bill that passed by historic margins. I understand some would like the administration to ignore these agreements and implement measures that Congress either specifically voted down or chose not to include in the Farm Bill. Can you assure me that your mission area will follow the will of Congress by honoring the commitments made in the 2008 Farm Bill?

Response:

I am aware of the changes made to the Packers and Stockyards Act in the 2008 farm bill to address concerns by producers and growers relating to fairness in the marketplace, specifically relating to contracts. If confirmed, I will work to advance these rules as expeditiously as possible and will keep you updated on this process as GIPSA works to carry out the requirements set by Congress. I will also seek your input when the rules are published.

I appreciate that issues relating to the marketplace and enforcement issues can be very complex and require needed dialogue across all sectors of the industry. I know that there can be strong views on both sides with these issues and I want to have the benefit of learning as much as I can from all perspectives.

Senator Thad Cochran

1) **Question:**

Mr. Avalos, the Department of Agriculture is working to finalize a rule allowing for the importation of cooked pork skins subject to certain processes to protect public health. When do you expect the Department to finalize this important rule? Also, do you believe the Department should follow different rules for beef and cooked pork skins when approving countries for imports? I ask that you review this issue and work to finalize the rule.

Response:

Although I do not know when the Department plans to finalize the rule on cooked pork skins, if confirmed, I will certainly look into this upon my arrival at USDA and see where the rule is in the process and work to move it along. I understand that the Department may receive many requests in any given year for different types of animal products to be let into the country, and that these products can be treated or handled in a variety of ways to mitigate potential disease risks. If confirmed, I would like to have an opportunity to assess and review the process that is used for prioritizing these types of commodity import requests and determine if changes should be recommended.

Senator Charles Grassley

1) **Question:**

Specifically related to Packers and Stockyards Program, how do you intend to make sure there is greater enforcement of the competition provisions of the P&S Act?

Response:

A fair and competitive marketplace for livestock and poultry is important to me and I want to ensure the Packers and Stockyards Act is fully enforced. If confirmed, I will work with the Grain Inspection, Packers and Stockyards Administration (GIPSA) to ensure it is structured and staffed in the most appropriate way to handle competition investigations. I also want to do a review of the existing regulations to ensure they are current for today's marketplace.

I am also aware that USDA is undertaking rules to carry out the farm bill's Livestock Title, and I will work to move them along as quickly as possible.

2) **Question:**

One of the most critical jobs within the MRP mission area is the biotechnology approval process at the Animal Plant Health Inspection Service. The U.S. is the leader in developing and using biotechnology and it should remain that way. However, over the last decade the time to deregulate these new products has slowed considerably. Will you make deregulation a priority within your mission area and can you assure me that these decisions continue to be based on science?

Response:

Advances over the years for plant biotech have brought significant benefits to producers and our food security. If confirmed, one of my top priorities as Under Secretary would be to support and uphold a science-based regulatory process and to also ensure that our regulatory process is robust enough to address the evolving nature of biotechnology.

Senate Committee on Agriculture, Nutrition & Forestry
 Nomination Hearing
 Questions for the Record
 Commissioner Bart Chilton
 September 30, 2009

Chair Blanche Lincoln

1) Question one. On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

You are correct that the cotton markets became dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. I requested an investigation (which had not begun) on this matter because of those very concerns. The Commission would be pleased to provide you with a comprehensive confidential briefing at your convenience on this matter. In addition, I have urged that this report be made public as soon as possible and that all aspect of the report that can be made public are available to ensure optimum transparency. It is my hope and expectation that the Commission will be able to make its findings public in the near future.

Senator Max Baucus

1) Question one. Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

Should the Commission is be given authority over carbon market trading, we will use our full authority to ensure transparency and accountability. This would include our complete enforcement and surveillance authorities such as large trader reporting and all other oversight authorities that are currently applicable to exchange trading of derivatives. In

addition, I believe it is important to ensure that there is a seamless market for all transactions and that can be best achieved through a single agency regulation of both the derivative and cash markets. Furthermore, I support ensuring that all significant trades related to these markets are done so in a regulated fashion and that any over-the-counter (OTC) trading is minimal and does not have the prospect of influencing the regulated price discovery process. Finally, by ensuring safe, sound, secure and transparent markets, derivatives industry participants will help create deep and liquid markets.

Senator Pat Roberts

- 1) **Question one. What is your definition of “systemic risk?” Do you believe every OTC participant or product creates “systemic risk” to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a “systemic risk” as some are suggesting?**

Section 3 of the Commodity Exchange Act charges the Commission with protecting against systemic risk, that is, financial system risk ensuing from transactions, series of transactions or events that have ripple effects across the broader economy. Certainly, every OTC product or participant does not present systemic risk to the financial market system, nor do I believe that the Administration's proposal regarding OTC regulatory reform treats them as such. The proposal's two-tiered approach--to bring more consistent oversight to standardized OTC products and to enhance prudential requirements for dealers in non-standardized products--is, I believe, a tailored approach to addressing potential risks to the financial system in order to avoid another financial market crisis

- 2) **Question two. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?**

With regard to the creation of a systemic risk regulator, I believe that this is a response to finding an single entity that can see aggregate risks common to financial market participants in various market sectors, the intent of which is, again, to lessen risks to the financial market system. I do not believe that the development of such an oversight system would have the perverse effect of creating barriers to entry and therefore increasing systemic risks.

Senator Charles E. Grassley

- 1) **Question one. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Comissinner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more**

transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?

The Commission, under the leadership of Chairman Gensler, had made significant improvements in enhancing transparency in energy and agricultural markets, including enhancements to commitment of trader reports and index trading reports, and we've also moved forward in the areas of consideration of position limits and hedging exemptions in finite commodity markets. As to the latter issues, I believe it is important that, at the same time the Commission considers how to impose reasonable and rational speculative position limits in finite commodities, we should be mindful of the OTC regulatory reform efforts currently under consideration by Congress, to ensure that our efforts at the CFTC do not have perverse consequences of moving currently regulated markets into what are now opaque venues. I am by no means advocating that the Commission wait for Congress to act; I am, however, noting that the Commission should ensure it take this dual track of regulatory and legislative efforts into consideration as it moves forwards in consideration of establishment of position limits.

- 2) **In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?**

Crude oil prices reached their apogee in July 2008, and as you correctly point out, there was a great deal of discussion at that time in Congressional hearings, at the Commission, and in the media as to whether speculative position limits should be imposed. It appears that, at least in part, these discussions--indicating to some that there was a possibility of legislative or regulatory action to limit speculative activity--did have some effect on trader activity, resulting in reduction of speculative long positions. While this certainly does not account for all of the decrease in crude oil prices since the highs of summer 2008, it appears that it had some effect. As I've said, I do not believe that speculators are "price drivers," only that their presence in the markets can have some price effects. Moreover, I believe that appropriate speculative trading is a necessary component to deep, liquid, properly functioning future markets.

Senator Amy Klobuchar

- 1) **Question one. In its 35-year history, the Commodity Futures Trading Commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?**

Thank you for the question, a recent federal court case in Texas exemplifies the need to amend our manipulation standard. In 2007, the CFTC settled the BP manipulation case for an unprecedented amount of \$303 million--the largest settlement in the history of the CFTC. The Department of Justice (DOJ) followed that case by bringing a criminal case against four of the participants in the scheme. Two weeks ago, the Texas judge in that case had to throw out the manipulation charge against those four, because (although he made it clear he didn't condone their behavior) he said that, in essence, the CFTC manipulation standard simply could not be met.

When comparing the CFTC's manipulation standard with that of the SEC, the SEC has a much easier legal hurdle to clear. The Federal Energy Regulatory Commission (FERC) and the Federal Trade Commission (FTC) have standards similar to the SEC's its "10b-5 rule" --which is their manipulation standard. To be more precise, under applicable case law the CFTC is required to prove "specific intent" to manipulate. That is a very difficult standard to reach, not to mention that it leaves a lot of space for mischief that is clearly prohibited by the Act, yet not categorically outlawed. In addition, our case law requires that we prove an artificial price exists, that the defendant had market power to move the price, and that he or she actually did cause the artificial price. Particularly in today's complex markets, proving "artificial price" can be a daunting task, which more often than not comes down to a "battle of the experts" in court. Because these requirements are so onerous, we often end up moving to a less significant charge of "attempted manipulation," which requires only proving intent and some act showing that intent. This is still a high standard, but is much easier than proving up a full manipulation case. I'm not saying that the answer is wholesale adoption of the SEC manipulation standard, but clearly, as Senator Cantwell and others have recently noted, we need to do something different at the CFTC. The status quo simply isn't good enough.

2) Question two. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Given current law, (with very rare exceptions) it is an inefficient and ineffective use of time and taxpayer dollars to prosecute financial crimes under our manipulation standard. With a new, more appropriate standard, we can prosecute and actually deter more manipulation events. I will note, however, that while we have a difficult time prosecuting manipulation cases, we are very good at prosecuting attempted manipulation cases and other violations of the CEA. In fact, our enforcement division is superb. At any one time, for example, we are investigating anywhere from 750 to 1,000 individuals or entities. We are one of the few government agencies who can say that the amount that we assess in fines and penalties could actually pay for our annual budget.

Senator Maria Cantwell

1) Question one. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the

commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?

Yes, I believe that the trading strategies of "non-traditional speculators"---those entities who take long, passive positions in the futures market and keep them indefinitely--can affect futures market prices, and that this price effect in the futures market can result in price changes in the cash commodity markets.

- 2) Question two. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?**

Yes, I fully support the Administration's proposal to bring needed transparency and federal oversight to the currently unregulated OTC markets. I am supportive of Chairman Gensler's additional recommendations included in his August 17, 2009 letter to Chairman Harkin and Ranking Member Chambliss, and I believe they highlight the need to address issues in the OTC provisions of the Administration's proposal, particularly the foreign exchange swap issue, the appropriate definition of "standardized" swaps, and dual regulation of "mixed swaps."

- 3) Question three. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?**

Yes, I believe that the Commission should address imposition of position limits in appropriate circumstances in finite commodities such as energies as metals. These limits have worked well in the agricultural arena for decades, and I believe that Commission-set

federal limits could bring needed oversight to other finite commodities that are critical to the American economy. I believe it is important that, at the same time the Commission considers how to impose reasonable and rational speculative position limits in finite commodities, we should be mindful of the OTC regulatory reform efforts currently under consideration by Congress, to ensure that our efforts at the CFTC do not have perverse consequences of moving currently regulated markets into what are now opaque venues. I am by no means advocating that the Commission wait for Congress to act; I am, however, noting that the Commission should ensure it take this dual track of regulatory and legislative efforts into consideration as it moves forwards in consideration of establishment of position limits.

- 4) **Question four. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?**

Yes, if it is done properly. I believe we need to both address the issue of position limits and at the same time review the important issue of addressing our current bona fide hedge exemption definition. Moving forward on the former with no consideration of the latter could make our efforts ineffective and not achieve the objectives that we are instructed to pursue under the Commodity Exchange Act.

- 5) **Question five. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I support consideration of all appropriate efforts to provide the agency with adequate funding to oversee regulated exchanges and market participants. I believe there is a public interest in ensuring that these markets operate efficiently and effectively and therefore believe that tax dollars should be used for needed increases in our regulatory efforts. That said, the most important thing to me is gaining the needed resources.

- 6) **Question six. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove “specific intent” to do harm, a much more difficult standard to prove than the “recklessness” standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC’s weaker anti-manipulation standard, market “manipulation cases generally have not fared well.” In fact, the standard is so weak that in the CFTC’s 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the “recklessness” standard instead of the current “specific intent” standard, how would this improve the Commission’s ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?**

I believe that a legislative change to provide the Commission with an "easier to prove" manipulation standard is critically important, and I thank you for your leadership on this important issue. As you correctly note, the current standard simply is ineffective in allowing the agency to detect, deter, and prosecute manipulation in America's commodity markets. This is not due to a lack of expertise or effort on the part of our enforcement staff; on the contrary, they do an excellent job, but their hands are tied by the almost impossibly high legal standard developed under manipulation case law. This is evidenced by a recent federal court case in Texas, a DOJ follow-on to CFTC's \$303 million BP civil manipulation settlement in 2007, in which the district court judge noted that, while he didn't condone the conduct of the four defendants involved in the scheme, he could not find them guilty of manipulation under the onerous commodities manipulation standard. A change such as your suggest would improve our ability to carry out the mission of the Commodity Exchange Act. We need a change in our law, and I fully and strongly support a legislative change to make that happen.

- 7) **Question seven. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the “Treasury Proposal to Regulate OTC Derivatives” and “CFTC Legislative Language” as it relates to this proposal. In reviewing GMAC membership as posted on the Commission’s website, it appears that the committee’s membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry.**

While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

The GMAC may hold a meeting at the discretion of the Chair, Commissioner Sommers; at this point, no firm date has been set for a meeting. With regard to future meetings of all agency advisory committees, I have in the past and will continue to fully support broad and diverse membership on such committees. In fact, as to the Energy and Environmental Markets Advisory Committee, which I chair, in the past year I significantly expanded not only the scope of the committee's mandate, but also the representation on the committee to ensure that consumer groups and others who formerly had not had a voice in that venue were included in the membership. I commit to continuing to ensure that membership of any CFTC advisory Committee fully complies with the requirements of the Federal Advisory Committee Act.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the Record

Scott O'Malia
September 30, 2009

Senator Charles Grassley

- 1) **When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?**

Under the leadership of former Acting Chairman Walt Lukken and Chairman Gary Gensler, the CFTC has expanded the collection of data as well as improved the fidelity of this information to better understand what impact non-commercial traders have had on the market. I support these efforts to bring transparency to the market and improve the quality of the data. If confirmed, I look forward to effectively utilizing this data to make informed policy decisions.

- 2) **In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?**

I believe one of the most significant factors that contributed to the decline in global oil price was the drop in global demand which also reduced pressure on our global capacity. When the price began to decline speculators and others did leave the market. While global demand has declined and prices have fallen, nothing has been done to relieve the capacity constraints in global markets, which could lead to price increases in the future. I believe we will likely to see prices rise significantly in the next few years when the U.S. and global economies recover. The Department of Treasury has proposed a financial reform bill that would impose position limit on energy derivatives. This tool has been used effectively in agriculture markets for the past 70 years. If applied to other commodities of finite supply, including energy markets, I do believe it could contribute to slowing the growth in oil prices, but will not correct the fundamental long term supply and demand pressures.

Senator Pat Roberts

- 1) **What is your definition of “systemic risk?” Do you believe every OTC participant or product creates “systemic risk” to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a “systemic risk” as some are suggesting?**

Systemic risk is the risk posed to an entire market as opposed to commercial risk posed by an individual company. Because of the interconnectedness in many markets, poor performance of one company can affect the entire market or system, rather than being isolated to the company with the poor performance. OTC derivatives are one way this interconnectedness proliferates through the system. However, not every derivative contract presents the same level of risk or capacity to destabilize markets. The Department of Treasury has offered a reform proposal that would regulate standard contracts and establish new risk based standards for customized products. If confirmed, I am committed to working with Congress and the Administration to develop legislative or regulatory proposals that strike the appropriate balance to enable commercial entities to cost-effectively hedge their risk while helping to avoid a repeat of the current financial crisis.

- 2) **This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?**

I believe we must ensure that we have completely transparent markets that enable all commercial participants to cost-effectively hedge their risk. This requires sufficient liquidity and an adequate number of counterparties to enable commercial entities to hedge their risk. I share your views that we should not create barriers to entry that prevent commercial interests from accessing these markets, which might leave participants vulnerable to commodity risk or encourage them to utilize foreign trading venues.

Senator Max Baucus

- 1) **Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.**

I believe the CFTC should be given authority over a carbon market, if Congress passes a cap and trade bill. The CFTC already regulates the small, but existing emissions trading systems and has the responsibility to oversee futures markets on regulated exchanges just like similar commodities. The CFTC also has regulations against manipulation and fraud. The Administration has proposed new rules to expand CFTC's authority over OTC markets which would greatly expand transparency in these markets. In order to ensure there is adequate liquidity, market participant must continue to be able to access transparent markets with low-barriers to entry. In order to carry out this mission, the CFTC will need additional personnel and resources to adequately oversee this potentially massive market.

Senator Amy Klobuchar

- 1) **In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?**

You are correct; the CFTC has only one successful prosecution. To obtain a conviction, the CFTC must be able to prove intent and that the defendant created an artificial price. The recent decision by the U.S. District Court in *U.S. v. Radley* highlights the challenges in obtaining a criminal conviction for manipulation. If confirmed, I will work with the Commission, the General Counsel and Division of Enforcement to review these standards and to identify appropriate regulatory reforms and recommend legislation that can provide the necessary tools in order to provide the CFTC with the necessary legal authority to prosecute manipulation in these markets.

- 2) **How will you ensure that the CFTC employs its authority to prosecute market manipulators?**

If confirmed, I intend to utilize the existing authorities to prosecute manipulation and attempt to manipulate. As I noted in the previous question, I will work with the Commission experts to determine what additional reforms are necessary. Further, I am committed to enforcing all violations of the Commodity Exchange Act. For these markets to work effectively, it is essential that all participants have the confidence that these markets are free from fraud and manipulation.

Senator Maria Cantwell

1. **Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?**

Yes, I agree all trading, including speculative trading, can have an impact on the futures price. Participants in the cash market often look to the futures for pricing information.

2. **On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?**

I support the Treasury initiatives to bring greater oversight to OTC markets, increase the utilization of clearing to enhance transparency and reduce systemic risk, and reduce the opportunity for abusive trading practices in our markets. I believe the Treasury proposal is a strong step towards appropriate regulation of the OTC markets, but I agree with Chairman Gensler that there are improvements that can and should be made. If confirmed, I look forward to working with Congress and the expert staff at the CFTC to ensure appropriate regulation of the OTC markets is enacted as soon as possible.

3. **The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities? Yes, I support the appropriate application of position limits for energy commodities. As the process proceeds, we should remain mindful of the broader goal of the Treasury proposal to bring more transactions under the oversight of market regulators. We must ensure that any position limit proposal does not have the effect of driving transactions from currently regulated and transparent markets to less regulated and opaque markets. I look forward to working with the Commission and Congress to develop a comprehensive position limit regime.**
4. **The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions**

have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

I believe existing hedge exemptions must be reassessed as part of the overall debate on position limits. To ensure position limits can be enforced across all markets will require additional authority from Congress. I am cognizant of the fact that any exemptions or loopholes that remain could enable traders to escape oversight using unregulated or international markets.

5. **The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade. During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?**

I agree with you that the CFTC is woefully underfunded. I believe the resources of both staff and appropriations are insufficient to properly oversee the incredible growth in these markets. I am aware of past proposals to fund the CFTC from the collection of fees. I strongly support an increase in the CFTC budget, and if this proposal is reconsidered by Congress, it is important that the fees do not impose a burden that would discourage the commercial risk management strategies, reduce liquidity, or drive trades to unregulated markets.

6. **Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one**

single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the “recklessness” standard instead of the current “specific intent” standard, how would this improve the Commission’s ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?

I agree with you that the CFTC must achieve a high standard to prove manipulation, including proving both intent and an artificial price among others. I also agree that other federal agencies do not have the same burden of proof. The recent decision by the U.S. District Court in *U.S. v. Radley* further highlights the challenges in obtaining a criminal conviction for manipulation. If confirmed, I will work with the Commission, the General Counsel and Division of Enforcement to review these standards and to identify appropriate regulatory reforms and recommend legislation that can provide the necessary tools in order to provide the CFTC with the necessary legal authority to prosecute manipulation in these markets.

7. **On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the “Treasury Proposal to Regulate OTC Derivatives” and “CFTC Legislative Language” as it relates to this proposal. In reviewing GMAC membership as posted on the Commission’s website, it appears that the committee’s membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC’s charter requires representation of U.S. and foreign exchanges and market participants, it also requires “end users most directly involved in and affected by market globalization.” Without end user and consumer participation, the committee may also not be “fairly balanced in terms of the points of view represented” as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure “fairly balanced in terms of the points of view represented” as required under the Federal Advisory Committee Act?**

I agree with you that the committee should include end users and consumers. If confirmed, I am committed to ensuring all CFTC committees comply with Federal Advisory Committee Act requirements to include a broad and diverse membership.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Harris Sherman
September 30, 2009

Senator Saxby Chambliss

1) **Question:**

As I mentioned at the hearing, I have been contacted by several constituents about your nomination. They raise concerns about your approach to managing federal, state and private land. Below is a list of the concerns I have received. Please respond to these concerns.

- Harris Sherman supports the Clinton-Babbitt Roadless rule and has worked in Colorado to revert to the Clinton-Babbitt Roadless Rule.
- He would be a threat to oil and gas, mining, coal mining, timber, grazing, gravel extraction and recreation and much more.
- According to residents of Colorado, Sherman used his position to extort or shake down money from oil and gas firms to fund his wildlife studies in return for his office not opposing their permits. In effect, he set up a "pay to play" approval process for oil and gas permits under the Colorado Dept. of Wildlife.
- He rewrote important environmental documents with the assistance of environmental activist groups negating public meetings and public comment.
- Environmental groups had special access under Harris not available to the public or other land users.
- He set up rules that infringed on private property.
- He set up a system whereby the CO Dept. of Wildlife could interfere with private contracts between farmers, ranchers and landowners and oil and gas and mining companies. He was able to blow up private contracts where he did not want oil and gas or mining operations to occur.
- It is likely he will give environmental groups special control over the US Forest Service. His pattern is to feather his own nest and he would likely use the Forest Service to do that as he did in Colorado.

Response:

I appreciate the opportunity to respond to these issues. I'm enclosing for the Record, a signed response I prepared in advance of this hearing in order to respond specifically to the claims made in the correspondence you have received.

2) Question:

The U.S. Department of Agriculture (USDA) seems to be carefully tracking stimulus projects which are supporting the use of wood fiber for the production of biomass energy. However, despite receiving more than \$500 million for hazardous fuels reduction projects, it appears that almost none of these projects will produce wood fiber that can be used by the traditional sawmill and paper mill industries. Please tell me how many ARRA projects have produced merchantable wood fiber? How much volume in board feet or cubic feet did those produce? Please tell me whether ARRA funds have been used to pay for the non-merchantable component of stewardship contracts, allowing the commercial component to go forward in down timber markets?

Response:

While I have not been a part of the team at USDA implementing this program, I have been apprised of facts about the American Recovery and Reinvestment Act of 2009 (ARRA). The ARRA provided \$1.15 billion to the Forest Service for conservation work on the nation's forest with a focus on providing and retaining jobs. Of the total, Congress appropriated \$650 million for Capital Improvement and Maintenance (CIM) projects and \$500 million for Wildland Fire Management (WFM) projects. Of the \$500 million for Wildland Fire Management, Congress further directed \$250 million to be used on Federal lands and \$250 million on State and Private lands and up to \$50 million of the total funding may be used to make wood-to-energy grants to promote increased utilization of biomass from Federal, State, and Private lands.

Again, while I have not been part of the implementation team, I understand that the Forest Service treated 68,000 acres of the 393,000 acres projected in planned projects. If confirmed, I look forward to working on implementation of the ARRA, as it provides a wealth of opportunities for resources and economic growth. I will study this issue more closely and ensure that we are achieving the maximum benefits possible with the resources provided for this program.

3) Question:

Recently, Secretary Vilsack announced his vision for the role of USDA in managing public and private forests. His "all lands" approach suggests that USDA will take an active role in matters affecting private forests, including their participation in climate change and energy policies and their role in addressing environmental services, like clean water and air and providing wildlife habitat. Working forests are a significant part of the jurisdiction of this committee, and we want to make sure that any policies affecting working forests are developed with the full participation of private forest

owners and this committee. Will you fully involve private forest owners in the development of USDA policies on working forests? Will you fully involve this committee in any policies USDA develops on working forests? Will you commit to working with the committee to explore policy opportunities together that will promote the benefits of working forests?

Response:

I applaud Secretary Vilsack for articulating a new and clear vision for forestry. Water quality and related natural resource issues are important to me and I am enthusiastic at the prospect of joining the team at USDA to help guide implement this vision. Clearly, it is important to take a collaborative approach in the headwaters, tributaries and looking at all of the actions on the land and how those actions interact with water quality. Without question, this will mean engaging state and private partners because of what is happening in private woodlots and across multi-jurisdictional and lands.

If confirmed, I look forward to keeping the Committee fully informed about our efforts to sustain private forest lands. The position of Under Secretary for Natural Resources and Environment affords a tremendous opportunity to work with State Forestry Agencies, Tribes, and a diverse range of partners and stakeholders. I am enthused about the full range of programs that seek to address forest protection, restoration, and management needs across the landscape from urban open space to rural headwaters.

Senator Tom Harkin

1) **Question:**

The Food, Conservation, and Energy Act of 2008 (FCEA) reflects carefully balanced and integrated compromises. Among the most important decisions by Congress was the agreement to include some \$4 billion in additional funding for conservation programs over 10 years above budget baseline levels. The policies enacted and funded in the legislation are being effectively used, for example, in the recently-announced Mississippi River Basin Initiative, which makes extensive use of funding from the Environmental Quality Incentives Program (EQIP) and authority from the Cooperative Conservation Partnership Initiative.

Do you agree that in light of the significant demands and need for conservation on agricultural land it would be unwise to cut back on the funding committed to conservation in the FCEA?

Response:

There is increasing national attention directed to the state of this country's water, air, soil and plant and animal resources. Regional initiatives such as the Chesapeake Bay, the Mississippi River Basin Healthy Watersheds, and the Great Lakes Reinvestment Act, all serve to highlight the needs for conservation funding. I understand that the NRCS has seen continuing substantial backlogs of unfunded applications for EQIP, WHIP, FRPP, and AMA. Also, the new Conservation Stewardship program has a great deal of interest around the country. Despite the troubled economy, all mandatory programs, including the Conservation Security Program, have shown healthy sign-ups in FY09. All of these figures demonstrate the growing need for, and interest in, Farm Bill Conservation Programs by private landowners and conservation partners. If confirmed, I look forward to working on Farm Bill implementation and specifically identifying ways to best utilize and support the Conservation Title investments that the Farm Bill provides.

2) **Question:**

In recent audits by the Department of Agriculture Office of Inspector General of the Wetlands Reserve Program and the Conservation Security Program the OIG identified failure to ensure compliance with the program requirements. This problem traces back, in my view, to insufficient funding being allocated for Natural Resources Conservation Service technical assistance personnel and activities so that conservationists can carry out conservation programs, including necessary compliance checks. For instance, the number of acres enrolled in the Wetlands Reserve program has continued to increase, and therefore the cost of monitoring and enforcing WRP easements has continued to rise, but the technical assistance support funding allocated for the program has stayed relatively flat at around 5 percent of total WRP funding. Currently, WRP technical assistance cost for monitoring and enforcement are an estimated \$12 an acre, but allocated funding for these activities are only around \$6 an acre.

How will you ensure that sufficient funding is allocated to NRCS technical assistance personnel and activities so that conservation programs can be carried out and delivered to farmers and ranchers properly, and so that NRCS can fulfill its core responsibility to enforce the statutory regulatory requirements of programs?

Response:

I have been briefed in general terms regarding the issue you raised. NRCS is looking for ways to increase its efficiency; thereby freeing up staff time to do the kind of work referenced in your question. Without question, technical assistance resources are vital to achieving success on all of our natural resources goals. This is true in terms of taking an "all lands" approach. It is true in terms of applying the resources

needed to help quantify and verify greenhouse gas mitigation steps. And, it is certainly true of effective and accountable implementation of the Farm Bill.

But beyond that, I am also interested in supporting the basic conservation infrastructure, planning and assistance needed to assist landowners, even in cases where no cost share or governmental financial investment is involved. If confirmed, I look forward to assisting and helping to lead a new budget allocation process with a goal of funding the field conservation needs first so that as many financial resources as possible can be directed to funding technical assistance personnel.

Senator Max Baucus

1) **Question:**

Congratulations on your nomination to be Undersecretary for Natural Resources and the Environment for the Department of Agriculture. I am pleased that the President has chosen someone with your experience dealing with issues facing the forests, prairies and water resources of the West.

If confirmed, you will oversee programs and implement authorities that have a major impact on the economy and natural environment of my state. One authority the Forest Service has at its disposal is the ability to enter into stewardship contracts that enable it to trade logs and other goods to help carry out projects that reduce hazardous fuels, improve watersheds and other important forest management goals.

Stewardship contracting is very popular in Montana, helping form collaborative partnerships among diverse groups of forest users such as the wood products industry, the conservation community and sportsmen. Stewardship contracting also makes good economic sense for the Service. On one ranger district in my state, stewardship contracting enabled the ranger to perform nearly \$1 million of service work for which the district did not have appropriated funds.

While I am pleased that use of stewardship contracting is gradually increasing, I want the Forest Service to do much more. Since the Service was given broader contracting authority in 2003, it has completed only 34 contracts in the Northern Region. Most other regions have completed even fewer. I would like to know if you, as undersecretary, would work to substantially increase use of stewardship contracting, not only in my state, but across the nation. Does the Forest Service need any additional authorities to improve and increase the use of stewardship contracting and agreements?

Response:

If confirmed, I would explore the feasibility of increasing the use of stewardship contracting. This could become an important part of the US Forest Service's tool box to achieve restoration work. I understand that the Forest Service is currently looking at options to increase the use of stewardship contracting where appropriate, in pursuit of the Secretary's forest restoration goals. I also understand that Stewardship contracting authority is currently a temporary authority that will expire in 2013. If confirmed, I would look closely at this issue and seek to gauge whether broader use of this tool could also be facilitated by alleviating constraints associated with the current requirement to fully obligate (fund) the cancellation liability at the time of contract award.

2) **Question:**

Additionally, some non-profit groups have told me the Forest Service has been inflexible in determining matching requirements for stewardship agreements. The stewardship authority provides Forest Service and Bureau of Land Management personnel the same discretion in establishing matching requirements. Yet, the Forest Service requires a 20 percent match from non-profits, while the BLM requires no firm match. These non-profits can be valuable partners in stewardship projects and the Service should be more creative in evaluating their contributions. I would like to know if you will take steps to encourage non-profit participation in stewardship agreements.

Response:

It is my understanding that current Forest Service policy provides the Regional Forester discretion to reduce the level of the required match to as low as 5%. Current Forest Service policy also allows the match to be either in cash or in an "in kind" contribution. I understand that these are both recent policy changes that seek to address the concern expressed by the non-profit partners and ameliorate the constraint. If confirmed, I look forward to being more fully briefed on these topics and determining what further action, if any, might be warranted.

Senator Debbie Stabenow

1) **Question:**

What is your understanding of the authority given to USDA by section 1245 of the Farm Bill, and how do you foresee this authority being carried out over the next several years?

Response:

The statutory section that you have highlighted in your question, is one that I am enthusiastic to work on, if confirmed. This section of the 2008 Farm Bill, "Environmental Services Markets," is intended to aid development of market-based approaches for environmental goods and services. The provision requires the Secretary of Agriculture to establish technical guidelines for measuring environmental services from conservation and other land management activities. Specifically, I understand that the section requires the Secretary to develop:

- Standards, guidelines and procedures for measuring environmental services benefits;
- Protocols for reporting and verifying these benefits;
- A registry to collect, record, and maintain information on benefits measured.
- Involve stakeholders

If confirmed, I look forward to being briefed more thoroughly on the work of the Office of Ecosystem Services and Markets. I also look forward to working on this issue closely and promoting the utilization of market based conservation opportunities.

2) Question:

As Congress continues to debate climate legislation, what can USDA be doing now to develop methodologies and standards for GHG emission reductions in agricultural and forestry offset projects?

Response:

I am looking forward to the opportunity to work closely on the issue of Climate Change and greenhouse gas emission reductions. I share the views of Secretary Vilsack and the Administration that climate change mitigation provides a wealth of opportunities for agriculture and for foresters. If confirmed, I would work to better bolster and coordinate our ongoing research efforts – both within USDA and throughout the scientific community. Some of the work that must be furthered in this area includes developing practical methods for verifying the results of carbon offset land management activities. Research will continue to be needed to reduce the uncertainty that remains in quantifying the life cycle GHG emissions for some forestry practices, such as prescribed fire and others. I am also looking forward to exploring the work of the Forest Inventory and Analysis and helping to promote forest landowner participation in potential offset programs.

If confirmed, I would also like to build on the substantial progress made to date in providing opportunities to increase the utilization of biomass to generate renewable energy and offset the use of fossil fuels. I believe that further progress can be made

both in our standard programs, but also within special funding and authorities provided through the Recovery Act. I look forward to working with you and other Members of the Committee in this regard.

3) **Question:**

The President has committed to and Congress is ready to pass over \$400 million for Great Lakes Restoration projects. This funding will build upon the work that many Great Lakes stakeholders have been working to develop for over 5 years. Given that your position with USDA would oversee some of the largest federal conservation programs, how can USDA play a more vital role in Great Lakes restoration process?

Response:

The Great Lakes Restoration Initiative Action plan is a clear example of great potential for the federal government to make great strides in water quality improvements. Led by the Environmental Protection Agency, 15 different federal agencies worked together to make the Great Lakes restoration a priority. I understand that USDA has worked collaboratively to articulate the most significant ecosystem problems and to define efforts to address them.

Secretary Vilsack has articulated an overarching focus for USDA grounded in principals of sustainability and restoration not only for federal land under USDA jurisdiction but all lands. Within this framework, Great Lakes Restoration would be a key priority for me, if confirmed.

4) **Question:**

Should you be confirmed, how can USDA better collaborate with EPA to ensure land management programs are more successful in the future?

Response:

I believe that both NRCS and the Forest Service have a long history of collaborating with EPA on a number of issues such as source water protection, watershed restoration, air quality, smart growth and urban land use, and best management practices for protection of water quality. If confirmed, I would want to further that relationship, both personally with the leaders of EPA, but also to help establish a better working professional relationship between our agencies at all levels. I would want to work closely together as we mutually address emerging challenges around issues like air quality, wildland fire and smoke, and watershed management. The

Forest Service will continue to provide sound advice to EPA to assure that associated regulations achieve their intended purposes without unintended consequences.

Senator John Barrasso, M.D.

1) **Question:**

In Wyoming, where more than half of the state is public land, we are keenly aware of the U.S. Forest Service responsibility for management of its lands. Currently, we face an unprecedented bark beetle infestation that threatens our forests and communities. If confirmed, how will you address the following management challenges related to this infestation?

Response:

I know from my experiences in Colorado, extensive tree mortality from the bark beetle epidemic has been devastating my state as well as Wyoming and Montana. The area affected (nearly 8 million acres in 2008), the number of species of trees and beetles involved, and the diversity of ownerships has presented management challenges. Dense and homogeneous stands, combined with drought and warmer temperatures, have favored bark beetle population increases. If confirmed, I would work closely with this Committee to identify how resources of our agencies can be best applied to meeting these challenges. Or, if the authorities and resources we are currently working within cannot achieve the desired objectives, we will work collaboratively with you to determine how we can fill those gaps.

a. **Question:**

Programmatic funding for Regions 2 and 4 of the U.S. Forest Service has historically fallen well below need. These regions have been disproportionately deprived of management resources. How will you address the funding needs for management of the bark beetle outbreak throughout Regions 2 and 4?

Response:

From my experiences in Colorado, I understand that throughout much of the Rockies, lodgepole pine forests are experiencing a severe and widespread epidemic of mountain pine beetle. In addition, national forests in the west are experiencing numerous major wildland fires. I understand that the agency acknowledges the issues and management challenges created by these forest health challenges. The extent of bark beetle infestations, in particular, precludes widespread treatments and I am told that the Forest Service and State partners are focusing on treatments in high priority

areas, such as the wildland-urban interface, recreational areas, water sources and ecologically significant areas.

If confirmed, I can commit that I would closely examine the allocation of resources among regions for this purpose, and determine what further actions are needed to make our bark beetle mitigation and recovery efforts as effective as possible.

b. Question:

U.S. Forest Service local managers are facing an unprecedented forest health event. What management authorities do you believe need to be adjusted to meet the challenges posed by this infestation? Specifically, how will the Department, under your direction, address each of those needs?

Response:

If confirmed, I would work hard and focus resources on the topic that you have raised in this question. In dealing with the suppression of the current infestation and prevention activities to reduce the susceptibility to future outbreaks, I would work with you and other Members of Congress to determine what, if any, additional resources or authorities might be needed.

c. Question:

Bark beetle infestation spreads beyond political boundaries. We must take a regional approach to management of our forests. Specifically, how will you promote regional action to regional management of the bark beetle infestation?

Response:

I understand that the Forest Service Region 2 has established the Bark Beetle Incident Management Team (IMT) to address the impacts of the infestation, and find ways to increase efficiencies to treat more acres with current funding. I am told that this IMT is coordinating activities among the various agencies affected to reduce hazardous fuels, capture the commercial value of trees to the maximum extent possible (i.e., timber sales & stewardship contracts), spraying trees in campgrounds, and the removal of hazardous trees in developed recreation areas, along roads and trails.

But the issue and approach raised in your question is an excellent one. It is important for leaders to look well beyond existing boundaries and job descriptions to deal with important priorities and emerging crises. If confirmed, I assure you that I will work

to apply resources to dealing with this problem in a manner that takes a holistic approach to the entire area affected.

2) Question:

Our forest products industry partners are struggling in this economy. Many of the industry partners who historically helped manage federal forests are no longer in business. This increases the burden on federal agencies and weakens our local communities. If confirmed, how will you promote business friendly practices at U.S. Forest Service to sustain and regrow the American forest products industry?

Response:

The issue raised in this question is one that I look forward to working on, if confirmed. The national economy and with it the forest products market has declined over the past several years to an extent that many timber sales throughout the country are no longer economic to harvest. This drastic decline in forest products markets is now in its third year and is greater in magnitude than a similar decline in the early 1980's. Timber sale purchasers are faced with great economic losses on existing timber sales and, in many cases, can be faced with bankruptcy if forced to log under existing contract terms. Secretary Vilsack has made it a priority to help rural Americans and build future economic opportunities. I see forests and specifically private forest products as a central part of this effort. Further, to achieve our forest restoration goals, we need an infrastructure to maximize investments. I look forward to getting in place at the Department, if confirmed, and working on an overall strategy with my counterparts within the Rural Development mission area and other colleagues to realize more opportunities for forest products and build the infrastructure needed for a restoration economy.

3) Question:

U.S. Forest Service recently proposed spending \$2.8 million of wildland fire management funding under PL 111-5, the "American Recovery and Reinvestment Act," in Washington, D.C. Of the 5.5 million acres of wildlands nationwide, as defined by the National Interagency Fire Center, Washington, D.C. has none. There is no need for wildland fire management funding in the District of Columbia. While the kind of State and Private Forestry projects proposed for Washington, D.C. have merit, wildland fire management funding should not be diverted for this purpose. U.S. Forest Service must prioritize its limited resources to meet its basic responsibilities. Wyoming communities depend upon adequate management of U.S. Forest Service lands and we demand that the agency get its priorities straight. If confirmed, how will you direct U.S. Forest Service to prioritize its wildland fire management budget in the future?

Response:

I have not been part of the team at USDA implementing the Recovery Act, although I am enthusiastic to assist USDA in this effort. The legislation contains so many opportunities for the nation, including helping natural resources and making our country more resilient to future conservation challenges.

I have only been briefed on general issues that you raise in your question but if confirmed, I look forward to working with our professional program staff to gain a full understanding of the program funding that has been provided to date and gauge the relative merits and priorities for this funding going forward.

4) Question:

If confirmed, will you join Secretary of Interior Ken Salazar in supporting west-wide good neighbor authority, that would allow BLM and U.S. Forest Service to enter cooperative agreements with the states to implement forest health projects?

Response:

Yes, and I further believe national good neighbor authority is warranted to help address forest health issues that challenge eastern forests across diverse land ownerships. In these times of limited resources, it is important to leverage workforce and technical capacities, all within existing environmental laws and regulations.

5) Question:

U.S. Forest Service renewal of grazing permits is continually backlogged. This is a detriment to public land ranchers and to the day-to-day operation of the U.S. Forest Service range management. If confirmed, specifically how will you address the permit backlog and improve the agency's handling of grazing permit renewals?

Response:

I am told that the Forest Service has developed a schedule, and is vigorously working towards completion of NEPA for all grazing allotments. If confirmed, I will work with the Forest Service and Congress to find the most expeditious means to complete the required NEPA to continue the use of National Forest System grazing allotments.

Honorable Saxby Chambliss
U.S. Senator
416 Russell Senate Office Building
Washington, DC 20510

Dear Senator Chambliss:

Thank you for the opportunity to respond to the e-mail you received from Mr. Jerry Peavy of Griffin, GA, concerning my nomination as Under Secretary at USDA.

The e-mail is an amalgam of vague, unspecified charges from unnamed sources about alleged actions I have taken in my capacity as Director of the Colorado Natural Resources Department. The claims made are untrue and unfairly malign me and my colleagues at the Department of Natural Resources.

As Director, I oversee Colorado's energy, water, wildlife, parks, and state lands programs. I also serve as Co-Chairman of the Governor's Forest Health Advisory Committee. The Department of Natural Resources has approximately nine divisions, 2,000 employees, and a \$200 million plus budget. Our work is very diverse and we seek to balance many competing concerns. Resource issues are often contentious and it is our job to reconcile as many of these competing interests/issues as possible while protecting the State's economy and environment.

Colorado is blessed with an unusually diverse and vibrant economy. Agriculture, tourism, hunting and fishing, energy, manufacturing, high technology, and government sectors are all important cogs in our economic engine. The State also has some of America's most beautiful, high quality environments including wilderness and roadless areas, national and state parks, valleys and grasslands. Blending the economic goals of our State with our desire to protect our environment is a primary goal of my department.

Reading between the lines of Mr. Peavy's e-mail, he appears to be complaining about the recent legislation and rule making concerning Colorado's oil and gas development. By way of background, since 1999, Colorado has experienced an eightfold increase in natural gas permits issued each year by the Oil & Gas Commission. Production of this resource often takes place in rural, relatively undeveloped areas with high scenic value. Often, these areas that have strong tourist, hunting and fishing, agriculture, retirement and second home economies. Because of the newness and pace of the oil and gas development, multiple concerns were raised by residents regarding protection of drinking and irrigation

water, impacts to wildlife, public health and safety issues, air quality, and general quality of life considerations.

Our Legislature passed a bill in early 2007 that expanded the Oil and Gas Commission to include not only industry members, but also citizens representing farming, mineral property owners, wildlife and local government. A new statutory mission was given to the Commission to foster oil and gas production in a manner consistent with the protection of the State's environment, wildlife, and public health and welfare. The Division of Wildlife and Health Department are now required to consult with the Oil and Gas Commission regarding wildlife and environment matters.

Rule-making followed the legislation. It was the most transparent, open and comprehensive rule-making in the State's history. Extending over 18 months, all parties (approximately 85) were given every opportunity to provide input to the Oil & Gas Commission. The Commission heard from industry, local governments, agriculture, sportsmen, homebuilders, royalty owners, property owners, and environmental groups. Every group had access and input into the process. No special access was given to any group nor did any group have more opportunity for input than anyone else. The process was open and transparent. Property rights were respected. The final rule-making was balanced and fair; it was unanimously supported by the Oil & Gas Commission including its 3 industry representatives.

Subsequently the Colorado Legislature reviewed and approved the rules, as required by Colorado law, and the Governor thereafter signed the rule-making package into law. Major newspapers throughout Colorado, including the Denver Post, Grand Junction Sentinel, and Durango Herald, supported the rules as balanced, moderate, and workable. Recently, representatives of the oil & gas industry have also pointed to the Colorado rules as a responsible way of addressing certain issues without the need for federal intervention in similar areas.

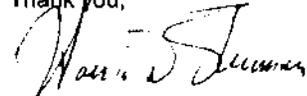
The Oil & Gas Commission is now implementing the new regulatory system. It works closely with the Division of Wildlife and Department of Health. As part of the process, the Division of Wildlife will meet periodically with operators to discuss mitigation of wildlife impacts and work to formulate agreements that can be proposed to the Oil and Gas Commission. The Division of Wildlife's views are recommendations only and it cannot dictate wildlife terms to any operator. Under the new system, landowners must agree to wildlife specific terms and conditions before they can become part of any permit.

Recently, Colorado, like other parts of the United States, has experienced a slowdown in gas production. This slowdown is a result of the drop in natural gas prices, the severe credit crunch, and the fact that Colorado's export pipelines are at capacity. Governor Ritter and I have repeatedly emphasized that Colorado's

natural gas industry is essential to the State's economy and can play a central role in dealing with the nation's climate change challenges. There is no reason that this industry cannot thrive while at the same time being respectful and compatible with the State's environment, public health and safety, and our wildlife resources.

If I am confirmed, I will bring a balanced approach to the Under Secretary's position. Recreation, timber, mining, oil and gas, grazing, and other economic activities have an important place on our national forest lands. These resources can be utilized in a fashion that is consistent with protection of wilderness and roadless areas, conservation, and restoration activities within these forest lands. My door is always open to any group or individual who wishes to meet and discuss these issues.

Thank you,

A handwritten signature in black ink, appearing to read "Harris D. Sherman". The signature is written in a cursive style with a large initial "H".

HARRIS D. SHERMAN

**Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Commissioner Jill Sommers
October 6, 2009**

Senator Maria Cantwell

1. Do you believe that speculation in commodity futures markets -- trading or investing in commodities by persons who do not produce or use the commodity in order to profit from commodity price changes -- can affect the price of commodity futures? Do you believe that speculation in futures markets affects the actual cash price of a commodity?

Yes, I believe that speculation can affect the price of commodity futures. Hedging, the taking of a position in the futures market opposite the position held in the cash market to minimize the risk of loss from an adverse price change, may also affect futures prices. While hedgers trade primarily to manage risk they also tend to bring a view to the market about where prices may be heading. In essence, futures prices are a consensus of the opinions of all who enter the market. The futures price of a commodity is linked to its cash price through the delivery process. As a result, futures and cash prices tend to move together. So, to the extent that speculation or hedging affects futures prices, they may also affect cash prices.

2. On August 11, the Department of the Treasury submitted to Congress its legislative proposal to regulate the over-the-counter (OTC) derivatives markets. While this proposal is a very important step, there are many areas where the proposal can be strengthened and tightened to fully protect our economy and prevent another financial crisis. On August 17, 2009, CFTC Chairman Gensler sent a letter to the Senate Agriculture Committee recommending specific important changes and additions to the Department of Treasury's legislative proposal. Do you support the Department of Treasury's OTC legislative proposal? In addition, do you support each recommendation included in Chairman Gensler's August 17, 2009, letter to the Senate Agriculture Committee to improve the Department of Treasury's OTC legislative proposal?

I believe the recommendations that are included in Chairman Gensler's letter add significant improvements to Treasury's OTC proposal and are intended to enhance the CFTC's ability to implement the much needed comprehensive financial market reforms.

3. The CFTC has the authority to establish position limits to prevent traders from acquiring large positions that could be used to manipulate the price of commodities traded on futures exchanges and to prevent price distortions at contract expiration. To protect against excessive speculation, the CFTC sets position limits on some agricultural commodities, but does not do so for energy products such as oil futures. In late July and early August, the CFTC held hearings to address the current application of and exemptions from position limits in energy markets. Do you support Commission-set position limits in energy commodities to ensure that excessive levels of speculation, even in the absence of manipulation, are not causing "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities?

I believe that appropriate position limits need to be set consistently across all markets in order to effectively address the issue of excessive speculation.

4. The CFTC has the authority to exempt the application of speculative position limits for bona fide hedging purposes as defined by the CFTC. Currently, bona fide hedging includes transactions to hedge against exposure a scope of financial activity with no connection to the underlying physical commodity or cash markets. These non-traditional hedges are being used to manage financial risk where transactions have nothing to do with managing commercial risk, allowing speculators seeking to gain price exposure in commodity markets. Since 1991, when the CFTC granted its first bona fide hedge exemption for a non-commercial hedging transaction, the use of swaps by various market participants to hedge price risk has grown substantially. On March 24, 2009, the CFTC published a concept release on eliminating the bona fide hedge exemption for swap dealers. The recommendation was part of the September 2008 "Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations" prepared as a result of Commission special calls for information from swap dealers and index traders issued in June and July 2008. Do you support eliminating the bona fide hedge exemption for non-commercial transactions?

The concept release the Commission published in March asked for comment on eliminating the bona fide hedge exemption for certain swap dealers and creating a new limited risk management exemption. Commission staff is in the process of analyzing the comments received. In addition, the Commission held three days of hearings in July and August and heard from a number of different markets participants regarding the application of position limits and exemptions. This is a complex issue but I believe a possible solution would enable the Commission to grant exemptions to only those market participants that can demonstrate a commercial risk.

5. The CFTC is underfunded in terms of both budget and staff. Today, the staff numbers approximately 490, a decline of nearly 20% from earlier in the decade.

During this time, markets have grown exponentially, and the issues the CFTC faces have increased in complexity. For many years, the President's budget has recommended that Congress impose a user fee on commodity market participants to fund part of the CFTC's activities. The CFTC is currently the only major U.S. financial regulator that is not at least partially funded through user fees. Do you support the imposition of user fees to fund CFTC activities?

Yes.

6. Current law makes it very difficult for the CFTC to effectively meet its mandate to enforce and deter market manipulation. This is because the CFTC must meet a more rigorous standard to prove market manipulation than other financial market regulatory agencies such as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and the Federal Trade Commission. The CFTC is currently the only major U.S. financial regulator that must prove "specific intent" to do harm, a much more difficult standard to prove than the "recklessness" standard employed by the SEC, FERC, and FTC. As a result, federal courts have recognized that, with the CFTC's weaker anti-manipulation standard, market "manipulation cases generally have not fared well." In fact, the standard is so weak that in the CFTC's 35-year history, it has only successfully prosecuted and won one single case of manipulation. If the CFTC were granted authority to prosecute manipulation cases under the "recklessness" standard instead of the current "specific intent" standard, how would this improve the Commission's ability to prevent, deter, and enforce market manipulation? Do you support legislation to lower the burden of proof the CFTC must meet in proving manipulation cases?

Under current law, to prove manipulation the Commission must establish that the accused: (1) had the ability to affect market prices; (2) specifically intended to do so; (3) created an artificial price; and (4) caused the artificial price. In addition to its general antimanipulation authority, the CEA grants the Commission authority to prosecute specific manipulative practices such as the false reporting of transactions or market information, exceeding position limits, wash sales, accommodation trades, and fictitious sales.

The CFTC has filed a total of 57 enforcement actions alleging manipulation and/or attempted manipulation. Of those cases, 55 were resolved in the agency's favor against some or all of the defendants through settlement, default, or administrative hearings (one of which was reversed by the Commission on appeal), one was lost after trial, one was won after trial in federal court (currently on appeal), and one remains pending. The civil monetary penalties imposed by the Commission from these cases total \$617,132,000.

The "recklessness" standard employed by the SEC, the FERC, and the FTC was a subject of discussion at joint meetings on market regulation harmonization held by the CFTC and the SEC on September 2 and 3, 2009. Some panelists observed that the types of manipulative schemes that occur in the securities markets are often different than the manipulative practices that occur in the commodities markets, with "pump and dump" cases being common in the securities markets as opposed to corners or squeezes in the commodities markets. The Commission's Office of General Counsel has expressed concern that the SEC's "recklessness" standard may not be sufficient to cover market power cases involving squeezes and corners in the commodities markets where the manipulator's conduct does not involve fraud or deception.

A recent case decided in the United States District Court for the Southern District of Texas, United States v. Radley, [cite], raises other concerns regarding the Commission's manipulation authority. In Radley the court ruled that the manipulation standard under Commodity Exchange Act failed to provide the defendants with sufficient notice that their conduct was illegal because it fails to define "artificial price." This decision could have far reaching implications for the Commission's enforcement program if other courts choose to follow its reasoning.

I believe that a statutory clarification of the Commission's manipulation authority would be prudent and that the precise nature of the clarification must be carefully studied and analyzed.

7. On September 10, 2009, the CFTC Global Markets Advisory Committee (GMAC) announced it would convene a meeting to examine, among other issues, the "Treasury Proposal to Regulate OTC Derivatives" and "CFTC Legislative Language" as it relates to this proposal. In reviewing GMAC membership as posted on the Commission's website, it appears that the committee's membership is comprised of representatives from the various U.S. exchanges, self-regulatory organizations and the financial services industry. While the GMAC's charter requires representation of U.S. and foreign exchanges and market participants, it also requires "end users most directly involved in and affected by market globalization." Without end user and consumer participation, the committee may also not be "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act. Before any future meeting of the GMAC is scheduled, will you commit to broadening its membership to include end users most directly involved in and affected by market globalization to ensure "fairly balanced in terms of the points of view represented" as required under the Federal Advisory Committee Act?

Yes.

Senator Max Baucus

1. Under a cap-and-trade system for carbon emissions, markets for trading of carbon allowances and carbon allowance derivatives are expected to develop. If the CFTC is granted oversight authority over such markets, please provide how the CFTC would ensure the following: (1) the markets are transparent; (2) the markets are free from abuse and unfair manipulation; and (3) the markets have sufficient liquidity.

If the CFTC is granted oversight over carbon allowances and related derivatives markets under a cap-and-trade system for carbon emissions, the CFTC would include these contracts in its ongoing oversight program for regulated U.S. futures and options markets. A key goal of this program is to detect and deter market manipulation and abusive trading practices. Effective oversight will likely help attract liquidity by building confidence in these emerging markets.

Senator Charles E. Grassley

1. This question is just for Ms. Sommers and Mr. O'Malia. When testifying before the Agriculture Committee last year, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent months go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?

Transparency is the cornerstone of a well functioning regulatory system. Regulators must have sufficient reliable information from the marketplace in order to ensure that the exchanges under their oversight are operating in an open and competitive manner, free from manipulative influences or other price distortions. The markets must also be transparent to market participants and the public.

The CFTC has taken a number of steps in the past year to bring greater transparency to the U.S. commodity futures and options markets. In accordance with recommendations contained in a September 2008 Staff Report on Commodity Swap Dealers and Index Traders, as of September 4, 2009, the Commission began publishing a new disaggregated Commitments of Traders (COT) report to shed light on the changing composition of large traders in the markets. Prior to the new disaggregated report, the Commission separated large

trader data into two categories: (1) commercial; and (2) noncommercial. The new report separates large trader data into four categories: (1) Producer/Merchant/Processor/User; (2) Swap Dealers; (3) Managed Money; and (4) Other Reportables. The Commission intends to also release in the near future three years of historical data for the new report.

In addition to the new disaggregated COT reports, the Commission is working to create a new COT report for all the financial markets to improve the transparency of those markets. The CFTC is also working on improvements to the agency's Form 40 and other methodologies to improve the accuracy of trader classifications.

Also beginning on September 4, 2009, the CFTC began releasing expanded index investment data detailing the notional values of index investment positions and the equivalent number of futures contracts for all U.S. markets with more than \$0.5 billion of reported net notional value in any one quarter. The new index investment data is more comprehensive than index data previously released by the Commission in that it covers more U.S. markets (not just selected agricultural markets) and includes both the gross long and gross short positions. The Commission intends to release this data on a quarterly basis with the goal of releasing it on a weekly basis in the future.

Upon announcing the new disaggregated COT reports and Index Investment Data, the Commission sought public comment on any possible further enhancements. I am hopeful that as the CFTC continues to receive additional data from markets and suggestions from the public on how to improve the collection and dissemination of this information, we will continue to refine and enhance the data we release to the public.

2. In a hearing last year in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25% overnight. At the high, the price of a barrel of oil was \$147 in the summer of 2008. Now it's under \$67. Did all these speculators suddenly leave the market? Why without CFTC regulation did the price actually drop to less than a 1/2 of the original price?

According to our economists, the CFTC's large trader and index investment data seem to show that speculative activity did not decrease significantly during this period of price collapse. I cannot determine the precise cause of the decline, but I suspect that many factors contributed, both global and domestic. Most oil market analysts argue that the extraordinary run up in price was caused by expectations

of insufficient supply due to world wide economic growth. These analysts typically explain that high prices eventually gave way to weak demand as the global economy moved into the current recession. Whatever the cause of the volatility of oil prices over the last two years, I support regulatory reform efforts that would subject oil trading across all markets to robust regulatory standards.

Senator Pat Roberts

1. What is your definition of "systemic risk?" Do you believe every OTC participant or product creates "systemic risk" to our national economy? If so why? If not, then why should Congress pass legislation that treats all participants and products as if they do create a "systemic risk" as some are suggesting?

In my view, systemic risk is the risk that the default of, or other financial difficulty experienced by one or more market participants, results in the dislocation or distress of the entire financial market. I do not believe that every OTC market participant or product has the potential to create, or does in fact create, systemic risk. Congress may want to consider that a very important distinction would be where the line is drawn between those market participants and products that are systemically important and those that are not.

2. This summer the Treasury Department proposed the creation of a systemic risk regulator to call for the imposition of capital requirements for participants in the OTC derivatives markets. Some view this as creating a significant barrier to entry, one that could in fact force many non-financial companies out of these markets. If the result of such a requirement was to leave only a few large market participants, wouldn't that enhance the possibility of systemic risk, rather than lessen it?

In the specific example that you have outlined, I believe it is important to ensure that all OTC derivatives market participants are well capitalized to engage in their respective market activities and that capital requirements are set on the basis of the risk they pose to the system. This is the underlying policy of the CFTC's risk-based regulatory capital regime and it has served us well thus far. As Congress reviews the very important issues surrounding the implications of insufficient capital requirements there may be alternatives that could accomplish similar objectives. I am hopeful that any solutions that are considered will avoid requirements that create significant barriers to entry.

Senator Amy Klobuchar

1. In its 35-year history, the commodity futures trading commission has only successfully prosecuted one case of manipulation in the futures markets. In a recent speech and in your testimony, you noted that the CFTC has to prove that someone "specifically intended" to manipulate prices. As a former prosecutor, I know chasing criminals isn't easy, but this standard would seem to make it even more difficult to go after criminals. What tools do you believe the CFTC needs to ensure market manipulators are effectively deterred or prosecuted?

Having the resources to hire and retain experienced enforcement staff and develop sophisticated information technology that can detect manipulative schemes and other trading abuses is the single greatest tool we could ask for to ensure the effectiveness of our enforcement efforts.

2. How will you ensure that the CFTC employs its authority to prosecute market manipulators?

Our Division of Enforcement does an excellent job and I will continue to fully support all of its efforts to investigate and prosecute any market manipulation or abusive trading practices in the markets we regulate.

Chairman Blanche Lincoln

On June 3, 2008, the CFTC announced that the Division of Enforcement was conducting an investigation of the February/March 2008 price run-up in the cotton futures contract. The Commission took the extraordinary step of announcing an ongoing investigation because of the concerns expressed by market participants at the April 2008 agricultural forum. The American Cotton Producers of the National Cotton Council told the CFTC forum that the cotton futures market was totally dysfunctional and that cotton producers were unable to hedge their price exposure and that their concerns extended to cotton buyers with whom growers had contracted new crop sales. It has now been nineteen months since the cotton market disruption. Can you provide this Committee with any additional information about the investigation or let us know when we might expect to see the official report of the investigation?

The cotton investigation was a very important undertaking for the Commission and our Division of Enforcement. I expect to see something publically released outlining the results of the investigation in the near future.

Senate Committee on Agriculture, Nutrition & Forestry
Nomination Hearing
Questions for the record
Mr. Kenneth Albert Spearman
September 30, 2009

Senator Chuck Grassley

1. As you know many in the agriculture sector and in particular livestock producers are struggling to stay afloat. On top of the tough economic times they are facing, now it seems as if credit is also drying up. Many banks have looked at their agricultural portfolio as a liability and that in turn has added another burden to our producers. What do you see as the role of the Farm Credit Administration in working with the farm credit system member banks to help these producers through this economically uncertain time?

Answer:

The Farm Credit System serves to provide creditworthy farmers, ranchers, their cooperatives, and others with access to dependable and competitive credit. This is the System's primary mission whether the agricultural economy is prosperous or during an economic downturn – similar to what is being experienced today by many in the dairy and livestock sectors.

The Farm Credit Administration's mission is to ensure the System's safety and soundness while also promulgating rules and regulations so that the System meets its Congressional mission. As a FCA Board Member, I will strive to meet the agency's goals of System safety and soundness while being mindful of the System's mission to serve the credit needs of America's farmers and ranchers in good times as well as not so good times. And, be especially aware and sensitive to the hardships that farmers and ranchers may endure during cyclical downturns and strive to give them my utmost consideration.

Senator Tom Harkin

1. Mr. Spearman, you serve as an outside board member for the AgFirst Farm Credit Bank, and this experience clearly provides you with valuable background and knowledge for serving on the board of the Farm Credit Administration (FCA). AgFirst is one of the institutions of the Farm Credit System (FCS), all of which you will be tasked with overseeing as a member of the FCA Board. To be sure, you have pledged that you will if confirmed resign from the AgFirst board and comply with the applicable conflict of interest and ethics requirements.

As a regulator you will be tasked with ensuring the safety and soundness of the FCS and also ensuring that lending by FCS institutions complies with the statutory objectives, requirements, and limitations of the Farm Credit Act of 1971, as amended. The recent turmoil in the global financial system obviously underscores the crucial importance of enforcing prudent safety and soundness standards. At the same time, as a board member of the FCA, you will have a responsibility to help facilitate FCS institutions in making affordable credit available to borrowers who are eligible under the Act.

In the light of your previous position on the board of a FCS institution, please describe carefully the approach you will take and any specific steps involved to make sure that in your new position as a member of the board of the FCA you will be truly objective, even-handed, and free of pre-determined conclusions in handling the various questions that will come before you.

Answer:

As an independently appointed board member of AgFirst, my role was to serve as an external, independent point of view to the Board of Directors. As a controller and auditor of Florida's Natural Growers, my position was to provide to the business cooperative an independent and objective appraisal of its financials and to ensure that it complied with applicable accounting practices.

I believe my education, training and 28 years of experience in accounting and auditing will serve me well as a FCA Board Member. Furthermore, I believe my time as an outside Director on the AgFirst Board has given me a great appreciation for the vital role the Farm Credit System plays in agricultural lending.

If confirmed as a FCA Board Member, my role is to be an arms-length regulator of the System's safety and soundness so that it may continue to serve its congressional mission to meet the needs of America's farmers and ranchers with access to competitive credit.

My career as an auditor has required my objectivity and independence which I believe will serve me well as a FCA Board Member. I come to this new endeavor with an open mind, no preconceived positions, and a clear understanding of my new role. Lastly, I will strive to be fair and thoughtful in all issues that come before the FCA.

**FINANCIAL SERVICES AND GENERAL GOVERNMENT
APPROPRIATIONS FOR FISCAL YEAR 2013**

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

H.R. 6020/S. 3301

AN ACT MAKING APPROPRIATIONS FOR FINANCIAL SERVICES AND
GENERAL GOVERNMENT FOR THE FISCAL YEAR ENDING SEPTEMBER
30, 2013, AND FOR OTHER PURPOSES

Commodity Futures Trading Commission
Department of the Treasury
Federal Communications Commission
General Services Administration

Printed for the use of the Committee on Appropriations



Available via the World Wide Web: [http://www.gpo.gov/fdsys/browse/
committee.action?chamber=senate&committee=appropriations](http://www.gpo.gov/fdsys/browse/committee.action?chamber=senate&committee=appropriations)

U.S. GOVERNMENT PRINTING OFFICE

72-314 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

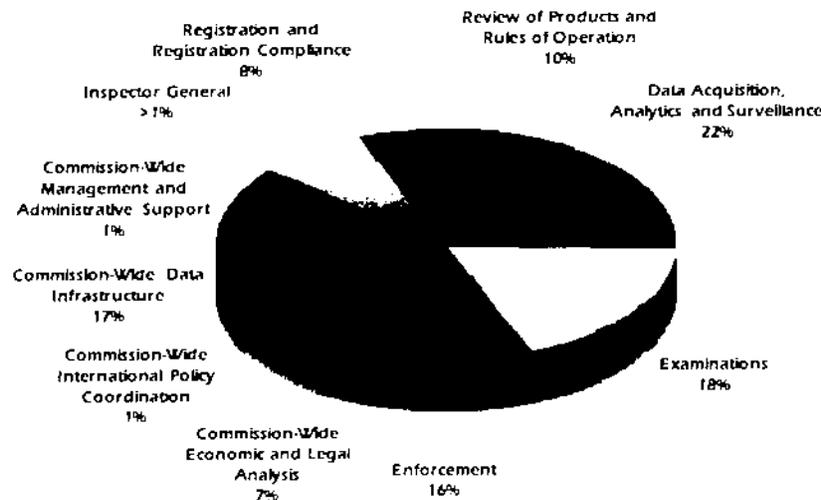


FIGURE 1. \$102.7 million budget increase by activity.

Senator DURBIN. Thank you, Chairman Gensler.

Because they waited patiently for me, I'm going to yield the opening round of questions to my colleague, Senator Lautenberg. And, then, turn to Senator Moran.

BUSINESS CONDUCT RULES

Senator LAUTENBERG. Thanks, Mr. Chairman. Thank you, Mr. Gensler.

The growth in your responsibility commensurate with the growth in the industry, of course, is quite a change over the years. And a lack of regulation in derivatives helped cause the financial crisis that we underwent.

CFTC requesting a significant budget increase, which some oppose. Is it fair to say that if the Congress fails to provide this funding increase, derivatives will remain largely unregulated?

Mr. GENSLER. I think, Senator, we will be successful in implementing the rules that you all have asked us to do, but I do think, just as in my basketball or football analogy if I stretch it, there wouldn't be folks to oversee the markets.

So it would be regulation by rule—we wouldn't be able to really do what's necessary to answer people's questions, to have effective cops on the beat, and, very importantly, I think, protect the American public.

Senator LAUTENBERG. An op-ed piece written recently by a departing Goldman Sachs employee got a lot of attention, and it suggested that the firm may not always deal with its clients in good faith.

The Wall Street Reform Law introduced new business conduct standards for swap dealers like Goldman Sachs. What's CFTC doing to enforce these standards and ensure fair dealing?

Mr. GENSLER. Well, I'm pleased to say that we were able to finalize the rules in sales practices and business conduct just this past

January. I think that as you noted, the financial industry is often a counterparty, is often on the other side of the table, from the commercial companies in your States.

And so that's why it's so important, I think, not only to finalize the rule, but then also to have the funding so that we can respond to inquiries, whistleblowers, and actually ensure that those sales practices are met.

POSITION LIMITS

Senator LAUTENBERG. There is obviously a real good, big vote of thanks, in terms of the President's request for a budget for your department.

And when we see what is involved, position limits, help ensure that unscrupulous traders can't manipulate, or will not be able to manipulate, oil and gas prices.

CFTC completed its work on position limits for energy derivatives last year, but they're not yet in effect, correct?

Mr. GENSLER. That's correct.

Senator LAUTENBERG. Gas prices continue to rise. Why are these limits still not in place?

Mr. GENSLER. We were able to finalize our rule writing on position limits last October, but there were two additional pieces that needed to be done.

One was that although the Congress laid out a pretty detailed definition of "swap", the Congress mandated that we work with the Securities and Exchange Commission (SEC) to "further define the word 'swap'."

We wanted to, I think, and the Congress wanted to, make sure that we didn't inadvertently bring people in who were using the cash markets—transactions called "forwards". I've had a lot of conversations with Senator Moran about this.

I think we'll finalize that rule this spring. We need to finalize that, and then spot-month limits will go into effect. Second, we also needed some additional data. The way we finalized the rule in October was to provide that we needed to get at least one-more year's data to put in place the second part of the limits.

USER FEES

Senator LAUTENBERG. There's strong funding for the CFTC oversight is essential to preventing another financial meltdown. But the industry should have to pay its fair share.

CFTC is the only financial regulator that does not offset a portion of its costs through industry user fees. Would collecting user fees instead of depending exclusively on taxpayer funding be consistent with CFTC's ability to accomplish its mission?

Mr. GENSLER. Senator, I look forward to working with the Congress in any way you think is most appropriate to help ensure the public has a well-funded CFTC.

I know that President Obama has suggested, I think other Presidents in the past of both parties have suggested, possibly having fees. My view is whatever the Congress wants to do I would work with the authorizers and the appropriators to ensure full funding of the CFTC.

Senator LAUTENBERG. Thank you, Mr. Gensler. Senator Moran, your turn. And it's not just because you're the remaining member. It's that we recognize the quality of information.

CORE PRINCIPLES

Senator MORAN. You are so kind, Senator. Thank you.

Mr. Chairman, let's talk about a couple of issues that we seem to talk about regularly. I want to talk about position limits and core principles.

In regard to core principles, what I often hear from the futures industry is that they are overwhelmed by the volume, frequency, and speed at which CFTC is issuing new regulations. And, regardless, of your efforts to entertain meetings and round tables, there's a sense out there that while you're willing to sit down, you're not quite as willing to listen.

Most observers, I think, would reach the conclusion that during the difficulties our country experienced in 2008, regulated exchanges functioned well, in large part, due to the core-principle regime.

Instead of seizing on the strengths of the core-principle regime, CFTC under your leadership has systematically converted the core-principle regime to one of a prescriptive rule-based regime.

Why, Mr. Chairman, after the core principles served so well during the financial crisis are you still pursuing these rigid regulations that effectively dismantle core principles?

Mr. GENSLER. I, Senator, actually think that what we're doing is building upon what has worked well, as I think we both see in the futures world, and extending it to this swaps world.

Core principles are there for designated contract markets like the Kansas City Board of Trade. It's also there for the clearinghouses. In the clearinghouse context, we thought it's really critical that they do have robust risk management.

We finalized those rules last October, and we thought guidance, frankly, would not be enough because of the significant amount of risk being moved into, particularly, in the swaps area.

We have not yet finalized the ones on the exchanges, and we're still taking, even though officially our comment period closed a long time ago, we're still taking very much our time on this, taking more input on this.

And I would hope we could actually have additional meetings. If there are things in that area that you particularly want us to focus on, I'd like to know about that.

Because what we're trying to do there is really just make sure that it's extended to swaps, and that we're embodying in the final rules for designated contract markets, the best practices that the designated contract markets currently use in the futures market.

IMPLEMENTATION

Senator MORAN. We may have to have those conversations. And you've been kind to make that offer in the past, and I welcome that opportunity again.

It strikes me that we may be about to engage in the same back and forth that we had a year ago. But the implementation for dis-

cretionary rulemaking has grown since we talked a year ago. What I would call a haphazard nature of rulemaking.

Since your last appearance before the subcommittee, one of your rulemakings has been challenged in court. Published remarks by the judge in that court case indicated that it's highly likely that the rule implementing position limits will be struck down.

What will your response be should that rule be rejected by the courts? Are you and CFTC staff planning for that possibility?

Mr. GENSLER. In terms of implementation phasing, I think that we very much took your advice and guidance last year. Around spring, we actually put out for public response and comment 13 concepts around implementation phasing.

Senator MORAN. So I'm now responsible for the mosaic.

Mr. GENSLER. No. I think your advice was about seeking public input on implementation phasing.

Senator MORAN. Okay.

Mr. GENSLER. The word "mosaic" was something I've used. And I will try not to use it again.

We got a 60-day public comment period and 2 full days of round tables: they were very beneficial. We've not finalized our rules in the 1 year since the passage of the Dodd-Frank Act. Here we're almost 2 years out, and we've not finalized.

We're not trying to do this against a clock—I know when I first said that, people didn't believe me—but here we are almost 2 years, and we're maybe halfway through the final rules. We've got a lot still to do, and we're still not trying to do this against a clock. We're trying to do it in a balanced way.

And in terms of phasing, we've even put out some specific rules for comment in the fall, in September, about the phasing of the clearing mandate and the trading mandate and the like. And that has been very beneficial to get that public input. We then phase in each of our individual rules. Sometimes we give a year to get something in place, 6 months and the like.

POSITION LIMITS

On position limits more specifically, Senator, the first thing I would do is turn to our attorneys and probably personally read whatever opinion comes out of the judge to see what they've said.

It's part of our democratic process that anything that we do, somebody could move into a court. I believe that what we did in October, in finalizing the position limits rules, was consistent with the congressional mandate, the strong mandate that we move forward and implement position limits, not only for futures, but also for swaps.

But, of course, if a judge has a different view on that, then we'll take a very close look at what he says.

Senator MORAN. When do you expect that decision?

Mr. GENSLER. Well, right now, I think we're just awaiting, the litigants had a preliminary injunctive motion, and we're waiting to see what the judge says on that.

I'm told, I'm not a lawyer, but I'm told that's generally, a relatively short process. So near term what I'm told that we'd hear from is just on that preliminary injunctive motion.

Senator MORAN. Have you had discussions about what if the rule is struck down? What does CFTC do next? I mean, you indicated you are going to read the decision by the court, but are you planning at this point if there is an adverse decision, what CFTC should do?

Mr. GENSLER. I don't have a plan yet because it would depend on wholly on what does the judge says.

We think, and I will say this personally too, we've followed the clear congressional direction on these limits. And what the limits are really it's to ensure that there's not concentration. We're not a price-setting agency. Some folks have maybe suggested otherwise.

We're really an agency to ensure that the markets are transparent, open and competitive, and that these exchanges work well, that the clearinghouses are safe.

Through the position limits, it's about ensuring that no one speculator has a sort of large footprint in that marketplace. They've been in place in the agricultural markets since the 1940s. Actually, working with the exchanges, they were in place in the energy markets in the 1980s and 1990s.

And I think the Congress really suggested that we sort of bring them back, but also extend them to the swaps marketplace. The reason we said we needed a delay is to get more information. So even in a swaps marketplace, we need that 1 year of data to use a percentage of the market formula that had existed when limits applied only to futures.

I think we first used this percentage of the market formula about 1980 or so. But, of course, if a judge says that he thinks we should do something different, we'd have to look obviously at what they said, and whether to appeal that and so forth.

Senator MORAN. Thank you, Mr. Chairman.

MARKET IMPACT ON PRICES

Senator DURBIN. Thank you very much, Senator Moran.

Chairman Gensler, in your opening remarks you said, and I quote, "CFTC is not a price-setting agency, but rising fuel prices make it clear why we need to have cops on the beat."

I'm trying to reconcile, if I wrote that down properly. I'm trying to reconcile that statement. You seem to suggest at the outset that what you do has no impact on price, but then go on to say, but because prices are going up, we have to do a better job.

Mr. GENSLER. Well, I think, Mr. Chairman, I thank you for that question. Because what we do as an agency, whether prices are low or high, is ensure the American public that those prices are arrived at where buyers and sellers meet in a transparent marketplace, free of fraud and manipulation.

Position limits assure that no one has sort of a large footprint, no speculator, has too large a concentration. I think, in times when the public is asking this question, it reminds us why we have to, I believe, have a well-funded agency to ensure that these markets are free of fraud and manipulation and they're as transparent as possible.

And that buyers and sellers come into that marketplace on a fair field of play.

Senator DURBIN. So, let me try to get down to some basics here so I can understand from a layman's point of view how I would explain this to people.

Let's assume for a moment we're talking about a futures market relative to plywood, which I think at one point was on the Chicago Board of Trade. And let's assume there are ten people interested who understand that they are talking about the future price of plywood and may have to take delivery of what they are buying.

I would assume that market would be less active, all things being equal, than a market with 100 people interested in the same issue. Is that a fair conclusion?

Mr. GENSLER. I think so.

Senator DURBIN. Now, let's take it to the next step. Let's assume it's not 100 people interested in the future price of plywood, but a thousand. And of those 1,000, 900 have no interest in plywood. They'd just as soon be dealing with apples at the Pip's next door.

They don't want to ever take delivery. They're never really interested in reaching that point in the transaction. Does that change the trade, the volatility of trading, perhaps, the price of plywood?

Mr. GENSLER. There's been a lot of studies and surveys on the role of speculation in these markets. I'm taking that to be the 900 that aren't taking delivery, and we actually reviewed them in this position limit rule last October. There were about 50 studies that were commenters sent in.

I suspect you'd probably not be surprised, about one-half of them said that the role of speculators had an influence on some of the things you said, price, and volatility. About half said, no.

I mean, and so you have the St. Louis Federal Reserve, and you have some very esteemed economists on one side saying, yes. And you have some other surveys and studies on the other side, suggesting, no.

So, we've summarized all that, and all five of the commissioners, you know, have the benefit of a very good chief economist in the office that has helped us with this.

Senator DURBIN. So, if there is a split opinion as to whether or not the number of trades, the number of traders, the interest in taking possession has any impact on price, let me ask you what the empirical evidence is.

If you're dealing with a commodity that really, and there are some, doesn't engage people as much as some other commodity, what is the nature of that market compared to the more active market in the next, no longer Pip's probably, but in the next trading theater?

Mr. GENSLER. Well, I think that there are two features. If the less-active market doesn't have a lot of fundamental research around and a lot of transparency around it, that market actually sometimes can be more easily manipulated, if there aren't people coming in and out.

But, the second feature, I think to the core of your question, is if the market as many of our markets are now 80 to 85 percent financial actors and speculators, and, you know, a smaller percent are the producers and merchants, I think that's part of the reason why we want a well-funded CFTC because the nature of the market is so heavily toward the financial actors and so heavily toward

the speculators, that it's that much more critical that we're watching over these markets to prevent manipulation.

And, second, that we do use position limits that no one speculator has such a large position that they start to be sort of the trend setter. They start and others sort of follow that lead in a pack.

Senator DURBIN. I have some more questions, but I'm going to yield to my colleague.

LEGAL SEGREGATION WITH OPERATIONAL COMINGLING (LSOC)

Senator MORAN. Mr. Chairman, thank you.

Mr. Chairman, it's my understanding that CFTC recently held a roundtable meeting to discuss the possibility of subjecting futures to a LSOC model. This sort of regulation, I think, at least appears to me, is discretionary as the Dodd-Frank Act only requires that you apply the LSOC model to cleared swaps.

Given that the LSOC for swaps will not come on-line until November of this year, will you comment—I'm sorry—will you commit to this subcommittee that you will hold off on pursuing the LSOC model for the futures market until the cost-benefit analysis for the LSOC for swaps has been fully evaluated over the course of the next few years?

Mr. GENSLER. I want to say we're in complete agreement. It is discretionary. It is something that came up actually in January as we were completing the new segregation for cleared swaps that a number of my fellow commissioners said, this is different than what we're doing for the futures world and have for some time.

And so I committed to my fellow commissioners, let's have a round table, and let the public tell us. And I think it was very beneficial.

It was also at this round table that people commented on greater enhancements to customer protection and different models. Staff's evaluating the comments and to the extent that staff puts forward a proposal whether it's this legal segregation for futures or other recommendations, all five of the Commissioners are weighing in.

We have a pretty active and busy agenda this spring and summer on the Dodd-Frank Act initiatives. So it might be disappointing for some that want LSOC for futures early.

I think it's just inevitable, if nothing else, for capacity reasons, that it will wait. And I think you're right, Senator, that because we're doing legal segregation for the swaps markets by November 8, we'll learn a lot from that as well.

Senator MORAN. So I think what you're telling me is we would not expect the LSOC for swaps to occur, if it does at all, until after the LSOC for futures?

Mr. GENSLER. I think that's just absolutely correct because we have a very significant agenda that the Congress has mandated for us.

We have enhancements to customer protection that I think are getting some very good input from the futures industry and from the exchanges. If there is a true consensus, on LSOC for futures, there is not that consensus at this stage.

Senator MORAN. Thank you for clarifying my misstatement, and I appreciate that sentiment, because one of the conversations that

you and I've had on an ongoing basis is my belief that you ought to focus on the things required by the Dodd-Frank Act that are mandatory as compared to the discretionary opportunities that the Dodd-Frank Act has given CFTC and prioritize.

And I think your answer to my question suggests that in this case, that's what you're doing.

Mr. GENSLER. Yes. I think, generally, that's the case. There are some things that are discretionary that we're taking up, I hope, soon to put out a proposed rule on getting more data about who owns accounts.

This is because of all this high-frequency trading, and so forth. I mean, so there are probably, I'm going to say, three or four things, I don't have the right count in my head, that we do anticipate in 2012 to do to enhance our oversight of the markets given high-frequency trading. That's actually maybe three.

And then there may be some things that come out of really thoughtful presentations from the futures industry and others on how to better enhance customer protection around segregated funds. And I think that's a critical part of our 2012 agenda.

AGRICULTURAL SWAPS

Senator MORAN. Mr. Chairman, let me raise a recent decision by CFTC to prevent clearing houses from self-certifying agricultural swaps for clearing.

As I understand it, rule 35 requires CFTC to treat agricultural swaps as they would all other swaps for purposes of self-certification.

Can you explain why you've chosen, it appears to circumvent rule 35, and treat agricultural swaps differently than other forms of swaps?

Mr. GENSLER. The Congress gave us authority in the Dodd-Frank Act to treat agricultural swaps differently. Then, we went through a lot of public comment to say we would treat them the same. That's where we ended up sometime last year after I think three public notices.

I don't know that we're treating them any differently, but one challenge for the whole swaps marketplace, not just agricultural swaps, is that we haven't completed our rules. It may well be that what you're referring to is that we haven't finalized some of the general clearing rules.

Senator MORAN. So, this process dealing with agricultural swaps and nonagricultural swaps, did it slow down the process of finalizing the rule?

Mr. GENSLER. We implemented 29 Dodd-Frank Act rules. We have about 20 to go, roughly. So, you know, maybe we'll finish this sometime this summer or fall, but again, it's not against a clock.

In the terms of agricultural swaps, they're to be treated identical to all the other swaps. There's a little bit of a legacy issue in that before the Dodd-Frank Act, agricultural swaps could not be cleared unless we did something called a—I think it's called a 4D order, but I apologize if I have the wrong letters.

And so, it's a little bit of this legacy issue of, I think, somebody has filed a petition in the last month or two, and there's a question, do they use this 4D order or do they use this new self-certification.

And I was briefed on it in the last day or two in anticipation of this hearing, but I might have just exhausted my knowledge on it.

Senator MORAN. Let me try one more time, not because you've exhausted your knowledge, but because I've been inarticulate in asking the question.

I think what I'm interested in knowing is the timeline of the ability to implement self-certification for agricultural swaps.

Mr. GENSLER. I know that it would most definitely come if we finalized a handful of new rules sometime this spring or summer. The other issue that I was briefed on in the last day was, is there some way to shorten the time?

And all I know is that our staff's looking at that to see if there's a way to do it.

Senator MORAN. Thank you for working your way through that question.

Mr. GENSLER. Okay.

SPECULATION AND PRICING

Senator DURBIN. Chairman Gensler, I'd like to address, as we started talking about at the outset, the connection between speculation and pricing.

And you said that the jury is split on that based on what you have read. I would say that for at least 20 of my colleagues, they have come down on the side that speculation is linked to higher prices.

And these colleagues sent you a letter, on March 5 of this year, calling on you to enact strong position limits to eliminate excessive oil speculation. I won't read the whole letter. You've received it.

For the record, I'll put it in the record here.

[The information follows:]

LETTER FROM THE CONGRESS OF THE UNITED STATES

MARCH 5, 2012.

Hon. GARY GENSLER, Chairman,
Commodity Futures Trading Commission, Washington, DC.

Hon. MARK WETJEN, Commissioner,
Commodity Futures Trading Commission, Washington, DC.

Hon. SCOTT WALLA, Commissioner,
Commodity Futures Trading Commission, Washington, DC.

Hon. BART CHILTON, Commissioner,
Commodity Futures Trading Commission, Washington, DC.

Hon. JILL SOMMERS, Commissioner,
Commodity Futures Trading Commission, Washington, DC.

DEAR CHAIRMAN GENSLER, AND COMMISSIONERS CHILTON, WETJEN, SOMMERS, AND O'MALLA: We are writing to urge you to immediately enact strong position limits to eliminate excessive oil speculation as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As you know, the Dodd-Frank Act mandated that your agency promulgate and enforce such limits no later than January 17, 2011. We are disappointed that, more than a year later, the Commission has not fulfilled this important regulatory duty.

Congress determined that speculative position limits are an effective and critically important tool to address excessive speculation in America's oil and gasoline markets. It is one of your primary duties—indeed, perhaps your most important—to ensure that the prices Americans pay for gasoline and heating oil are fair, and that the markets in which prices are discovered operate free from fraud, abuse, and manipulation.

There has been a major debate over the last several years as to whether spikes in oil prices are caused entirely by the fundamentals of supply and demand or

whether excessive speculation in the oil futures market is playing a major role. It is clear to us that debate has ended. Exxon Mobil, Goldman Sachs, the Saudi Arabian government, the American Trucking Association, Delta Airlines, the Petroleum Marketers Association of America, and even a report last year from the St. Louis Federal Reserve have all indicated that excessive oil speculation significantly increases oil and gasoline prices. According to a February 27, 2012 article in Forbes, excessive oil speculation "translates out into a premium for gasoline at the pump of \$.56 a gallon" based on a recent report from Goldman Sachs.

The facts bear this out. According to the Energy Information Administration, the supply of oil and gasoline is higher today than it was 3 years ago, when the national average price for a gallon of gasoline was just \$1.90. And, while the national average price of gasoline is now over \$3.70 a gallon, the demand for oil in the U.S. is at its lowest level since April of 1997. Nor is the global supply of oil at issue. According to the International Energy Agency, in the last quarter of 2011 the world oil supply rose by 1.3 million barrels per day while demand only increased by 0.7 million barrels per day. Yet, during this same period, the price of Texas light sweet crude rose by over 12 percent. Meanwhile, oil speculators now control over 80 percent of the energy futures market, a figure that has more than doubled over the past decade.

As the cost for American people to fill their gas tanks continues to skyrocket, the CFTC continues to drag its feet on imposing strict speculation limits to eliminate, prevent, or diminish excessive oil speculation as required by the Dodd-Frank Act. Although the CFTC has adopted initial position limits, they are not strong enough and not yet in force owing to industry opposition, delays in swaps oversight and data collection. This is simply unacceptable and must change.

We urge you to take immediate action to impose strong and meaningful position limits, and to utilize all authorities available to you to make sure that the price of oil and gasoline reflects the fundamentals of supply and demand. This could entail promulgation of rules only with regard to the currently regulated exchange markets. Swaps rules should also be implemented immediately, but even so, waiting for swaps rules to trigger all position limits is simply not adequate to protect consumers. We urge you to develop alternative methods of moving forward and to do so as swiftly and expeditiously as possible.

We have a responsibility to ensure that the price of oil is no longer allowed to be driven up by the same Wall Street speculators who caused the devastating recession that working families are now experiencing. That means that the CFTC must do what the law mandates and end excessive oil speculation once and for all.

Thank you for your attention to this important matter. We look forward to receiving your response.

Sincerely,

Daniel K. Akaka; Mark Begich; Richard Blumenthal; Barbara Boxer; Sherrod Brown; Benjamin L. Cardin; Robert P. Casey, Jr.; Al Franken; John F. Kerry; Amy Klobuchar; Patrick J. Leahy; Carl Levin; Joe Manchin, III; Robert Menendez; Jeff Merkley; Barbara A. Mikulski; Bill Nelson; Mark L. Pryor; Jack Reed; John D. Rockefeller, IV; Bernard Sanders; Tom Udall; Jim Wehr; Sheldon Whitehouse; Ron Wyden.

Gary L. Ackerman; Tammy Baldwin; Timothy H. Bishop; Suzanne Bonamici; Leonard L. Boswell; Bruce L. Braley; David N. Cicilline; Gerald E. "Gerry" Connolly; John Conyers, Jr.; Peter A. DeFazio; Rosa L. DeLauro; Lloyd Doggett; Joe Donnelly; Anna G. Eshoo; Bob Filner; Marcia L. Fudge.

Raúl M. Grijalva; Brian Higgins; Maurice D. Hinchey; Mazie Hirono; Michael M. Honda; Henry C. "Hank" Johnson, Jr.; Marcy Kaptur; Dale E. Kildee; Dennis J. Kucinich; Barbara Lee; Sander M. Levin; John Lewis; Zoe Lofgren; Jim McDermott.

Michael H. Michaud; Eleanor Holmes Norton; John W. Olver; Bill Pascrell, Jr.; Chellie Pingree; Mike Quigley; Nick J. Rahall, II; Lucille Roybal-Allard; Bobby L. Rnsh; Tim Ryan; Janice D. Schakowsky; Louise McIntosh Slaughter; Jackie Speier; Fortney Pete Stark; John F. Tierney; Paul Tonko; Peter Welch.

Senator DURBIN. Based on statements made from financial interest experts in the field and so forth, the belief is that speculation has driven up the price of a gallon of gasoline in America as much as 56 cents a gallon. That's what I believe Goldman Sachs reported in one of their recent reports, February 27 of this year.

So there's a bill that's also been filed; are you familiar with it? A bill that was filed today in the Senate?

Mr. GENSLER. As I was coming to this, I was briefed on it, but just briefed on it, just in the last 2 hours.

Senator DURBIN. Well, I have not seen it myself, so I can't tell you exactly what's in the bill.

But I do believe that it calls on you to use your emergency powers to establish these position limits when it comes to trading in terms of oil futures. And I'd like to ask you a few questions about that.

EMERGENCY AUTHORITY

First, would you tell me what you believe to be your authority under those emergency powers, or CFTC's authority I should say, when it comes to making that kind of a decision?

Mr. GENSLER. I think with only roughly 15 percent of the positions in the oil market or natural gas futures markets being the producers, merchants, and end users, and 80 to 85 percent being financial actors and speculators, it's kind of unarguable that financial actors and speculators aren't affecting prices. They are.

Studies are split on whether at any given time it's higher or lower and things like that. That's what they split on. But I think it's hard to say that 80 to 85 percent of the market don't influence price. They do. And they're part of it.

In terms of the emergency authorities, as I understand it, we've used it a handful of times, maybe four times, in the 1970s and early 1980s. There was even a court case at the time that I have not yet read the case, but I need to read it, where somebody challenged our use of it at the time.

It is about disruption of the forces of supply and demand in a particular marketplace, and the statute specifically refers to things about governmental actions or foreign governmental actions. So it was used, for instance, at that time, during the grain embargo.

Senator DURBIN. I'd like to interrupt you for just a second. This isn't a test on the final, so I want to make sure that we share the language.

The law defines emergency as market manipulation, an act of the U.S. or foreign government affecting a commodity, or any major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for a commodity.

Proceed. I'm not correcting you. I just wanted to enter that into the record.

Mr. GENSLER. No, you're helping me. You're helping me. As I recall it that fits the four times we brought emergency actions.

There was a supply disruption in the one case because of the grain embargo related to the Soviet invasion of Afghanistan. There were one or two other instances where a crop—potatoes—literally were, had a problem, and so there was a situation in your example where you couldn't deliver the plywood.

Back to your plywood example. The plywood couldn't be delivered. In that case, it was potatoes, that couldn't be delivered.

It's those types of circumstances. I've asked our general counsel, because I know this is a very important matter to many members of this body, to brief us at CFTC level, to brief us all on the legisla-

tive history and the legal, what really is the contour of the limits of that emergency authority.

Senator DURBIN. So, is that authority given to you as chairman, or to CFTC?

Mr. GENSLER. To the Commission, Sir.

Senator DURBIN. And so any designation or use of the emergency authority would require CFTC action, right?

Mr. GENSLER. That's correct.

Senator DURBIN. A majority vote by CFTC?

Mr. GENSLER. That's correct.

Senator DURBIN. All right. And, to your knowledge, does the Congress have any authority to order you to exercise that emergency power?

Mr. GENSLER. Not as I understand the statute, but, of course, you could change our laws.

EMERGENCY ACTIONS

Senator DURBIN. I guess the obvious question that follows once we understand the process under the law and the history of the law is whether or not you and the commissioners believe that we are facing 1 of the 3 options that would lead to emergency action.

And let's just suggest that, I guess, market manipulation, could be discussed, or more likely, any major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for a commodity.

So, are those things, those elements, 2 of the 3 in the law, have they been spelled out as it relates to gasoline prices or oil futures, to your satisfaction, at this point?

What I'm asking is, whether or not there's been an analysis done by your CFTC staff as to whether or not the current gasoline pricing and the oil price future trading would put you in a circumstance where you could logically consider one of these options for emergency authority, exercise of emergency authority?

Mr. GENSLER. I've actually asked for some advice as to what that provision means, how we've used it, what that court case in 1979 said about it, so that we can be best informed as to how narrow or broad that authority is.

As I understand it, we have used it in a very narrow sense when there was actual manipulation.

We've brought 30-plus manipulation cases in the history of our agency, and we've only gone and won in court once. I mean, our manipulation authority was very narrow, and now the Dodd-Frank Act has broadened it.

But those previous emergency actions were pre-targeted narrow provisions, but I've asked our general counsel's office working with others at the agency to best inform the five commissioners on that provision of the statute.

Senator DURBIN. I'm asking two questions, and I want to make sure that they're clear each.

The first, I think you've answered. That you have asked the appropriate legal authorities, people with background on the history of the agency, to talk about your authority under the law, and how it has been exercised in the past.

What I'm asking more specifically is whether or not you have asked whether or not the current situation with our rising gasoline prices and the speculation in the area of oil futures would apply to any of these three possible reasons to exercise your authority?

Mr. GENSLER. And I think I can best answer the first, but I'm limited in answering the second because I'm trying to understand the contours from our general counsel and our hardworking, dedicated folks at CFTC, how wide or narrow that is, the first before trying to answer the second.

But, I will say, historically, it's been used only in a very targeted way.

Senator DURBIN. So, have you at least started the factual inquiry about possible market disruption related to gasoline prices?

SURVEILLANCE TO DETECT EMERGENCIES

Mr. GENSLER. We meet as a Commission in a closed-door meeting every Friday, and we have for 30-plus years, and we put it in the Federal Register, people know we do this, to do surveillance on markets, from the grain markets to the interest rate markets to the energy markets.

And we have about 50 to 55 people in a surveillance unit that bring information to us in these closed-door sessions every Friday. The energy markets come up, as you would think, as a regular basis, as the grains do and the financials.

The staff is always tasked to come and bring to us matters, if they see issues, in these marketplaces. I mean I'm trying to—

Senator DURBIN. I understand the nature of your answer. I think you are carefully avoiding saying whether there's been any specific factual inquiry on anything until you have satisfied the first question.

Don't let me put words in your mouth, stop me at any point here. First question, about your authority, historic precedence, before you go to the next question, which will be raised by this bill and by the letter from the Senators, as to whether or not your authority can or should be exercised when it comes to gasoline prices.

SURVEILLANCE MEETINGS

Mr. GENSLER. But I want to assure you and the American public, our staff, even though it's, I believe, underfunded, our staff every day and every week is bringing to the Commission concerns if they think they see manipulation in these markets, if they think they see something about position limit violations and the like.

We're not waiting for anybody to say what the limits of emergency authority are. I mean, our agency, again, not a pricing agency, it is to ensure transparent markets, free of fraud and manipulation, and the people are following the rules of the road.

Senator DURBIN. Now, I'm going to ask a question. I already know the answer.

Can you tell me if your staff has produced any information for CFTC to consider at these weekly meetings relative to rising gasoline prices and the impact of speculation on oil futures?

Mr. GENSLER. We look at the statistics on a pretty regular basis. We actually publish to the market every Friday the size and scope

of the nonproducer merchant side, the speculative side, of the markets.

So we're looking at that, in the natural gas markets, in the heating oil markets, the oil markets, on a very regular basis.

Senator DURBIN. Are these Commission meetings public?

Mr. GENSLER. They're closed-door meetings under the Sunshine Act, but we publish, we put in the Federal Register every week, that we have these Friday meetings.

Senator DURBIN. You announce the meetings are taking place?

Mr. GENSLER. Yes. Oh, absolutely.

Senator DURBIN. But not the substance of your discussions?

Mr. GENSLER. That's correct, because we're talking about confidential information that the Congress has actually directed us under Commodity Exchange Act section 8 not to disclose material, about individuals and their transactions.

POSITION LIMITS

Senator DURBIN. I've gone way over my time. I'm going to yield back to Senator Moran for another round of questions, if he has them.

But the last thing I want to say is, CFTC has adopted a rule to implement position limits on 28 commodities including oil contracts as soon as the joint rule between CFTC and SEC defining swap is adopted, the rule-implementing position limits will go into effect?

Mr. GENSLER. For the spot month limits, that is correct.

Senator DURBIN. And, can you give me any indication of how soon that will occur?

Mr. GENSLER. We stand ready at CFTC to move forward whenever the SEC gives us the full document.

Senator DURBIN. Well, since we fund SEC, we'll tell them, at least, I'll tell them, to hurry along. I'm not sure if my colleague agrees with that position.

But I want to do it right. And I understand their work has been challenged in court, as yours has been, and most other agencies have faced. I want them to do it right, but I want them to do it in a timely way.

Senator Moran.

SPECULATION

Senator MORAN. Chairman, again, thank you.

Chairman Gensler, this conversation about speculation in the oil market, you indicate that about 85 percent of the crude oil futures market is made up of speculators.

Mr. GENSLER. Well, financial actors and speculators.

Senator MORAN. And the difference between financial actors and speculators?

Mr. GENSLER. Well, people, colloquially, use the word, but some swap dealers are part of that 85 percent, and they are helping others hedge. They have producers and merchants on the other side.

So the 80 to 85 percent are swap dealers, hedge funds, money managers, even pension funds sometimes are investing. And hedgers and speculators meet in a marketplace, but some financial actors would prefer not to be called speculators.

Senator MORAN. And I think your testimony was an indication that with that magnitude of speculation, there is a consequence to the price, either up or down, that's what you were indicating in the studies is what the consequence is, but there is a consequence to that level of speculation?

Mr. GENSLER. Well, I think that every participant in a marketplace can influence a price. Again, we're not a price-setting agency, but it's critical I think that we have an agency that brings a bright sunshine to that market, that it's transparent, free of fraud and manipulation.

We use the position limits to help limit any one sort of speculative party's footprint in the market place.

Senator MORAN. I just would indicate that when we use the word "speculation", it seems to have developed a negative connotation.

Mr. GENSLER. Not to me.

Senator MORAN. And you did differentiate between different, within that 85 percent, there's different actors.

Mr. GENSLER. That's correct.

Senator MORAN. And I think there's always a suggestion out there in today's media world, that speculation is something that causes bad things to happen.

But you just indicated that's not your belief. In fact, speculation, what benefits arise from those who speculate in markets, in the oil market.

GENESIS OF THE MARKET

Mr. GENSLER. I'd be glad to answer that.

I think that going back to the genesis of this market, and it happened in Senator Durbin's State, in Chicago, in the 1860s, when a wheat farmer or somebody growing corn, they needed to lock in a price at harvest time.

And they wanted to lock in that price so they could focus on what they really did well, and tilling the field, and so forth. And so they needed somebody on the other side, and the party on the other side is what we call a speculator.

So there's the hedger, the natural hedger, meeting the speculator in the marketplace, probably since Roman times. In the 1920s, the Congress said we need to regulate so that it's transparent.

And so we were founded inside the Department of Agriculture, and then by the 1970s, we became a Commission and you know the history.

But it's still a marketplace where hedgers and speculators meet. That the natural hedgers need to meet somebody on the other side. But what's critical is that we have clear rules of the road against manipulation.

I believe that the position limit authority is that no one speculator sort of has this big footprint, and that we have great transparency in the marketplace.

Senator MORAN. Speculation is useful to the economy including in establishing a market for oil and gasoline. And I guess the point you make is that you want to be careful about the magnitude of any one individual's position within that market.

Mr. GENSLER. That's right. That's right.

Senator MORAN. Thank you, Mr. Chairman. Mr. Chairman, I need to go to the Department of Homeland Security Appropriations Subcommittee hearing.

FUNDING NEEDED FOR NEW RESPONSIBILITIES

Senator DURBIN. Thank you very much, Senator Moran. You've been very patient. I thank you for that.

I want to kind of move into another area here and probably make a statement and ask you a question along the way.

Your current-year appropriation is in the range of \$205 million.

Mr. GENSLER. Yes.

Senator DURBIN. The President had requested close to \$300 million, I believe, for this current fiscal year.

Mr. GENSLER. Right. Correct, \$308 million.

Senator DURBIN. And so what you were given is dramatically less than the President's budget and less than what the Senate had suggested.

And my feeling is that your agency, based on your testimony and the clear evidence we have, needs more resources to deal with the challenges that you are facing and that we've given you by law, passed by the Congress, signed by the President.

It isn't as if you're dreaming up new assignments. We're sending them your way in volume as we move you from the well-known marketplaces like Chicago, which I'm very proud to represent, to a new world of swaps and over-the-counter (OTC) trading, that is dramatically larger in volume.

For the record, what is the difference if we can speculate, I guess we can do that here, if we can speculate, the difference in size between that regulated marketplace that we can see on the street in Chicago and what is going on over the counter?

What's the difference in size?

Mr. GENSLER. It's about eight times the size in terms of the aggregate dollar amounts. There's \$300 trillion notional in swaps, which is \$20 for every \$1 of goods and services produced by America.

Senator DURBIN. That is an indication of new assignments coming your way, to deal with that market, and to try to have appropriate oversight.

And so when the President asks for more resources, it's because you have a new and large responsibility coming.

Mr. GENSLER. That's right.

Senator DURBIN. Now, I have said to my friends in the industry, the Chicago Mercantile Exchange (CME), and others, that I have felt their position since I have been a Congressman and Senator, has been very clear and concise.

They believe that their strength in the marketplace is the fact that they do follow the rule of law. They are subject to oversight. There is transparency, and it is rare, I wouldn't say never, but it is rare that an embarrassing situation arises.

And that marketplace becomes a magnet for people all around the world because of those features. And that all depends on appropriate regulation from my point of view. And I think from theirs too. I don't want to put words in their mouth.

Now, there are people who argue that if the Congress does not give you the resources to do your job, appropriate regulation of not only the existing marketplace, but new market responsibilities like OTC, that the alternative should be a user fee, a transaction tax, mirroring the example of SEC, which generates its annual budget through fees collected.

And now is linked up more closely to the collection to the actual budget that they have to spend. And I, for one, have had misgivings about that because I question what will that do to the competitiveness of the American marketplace or CME, for example, against other countries with marketplaces that don't charge the same user fee or transaction tax.

Does it create a competitive disadvantage for the United States in what has become a global industry? For the record, would you like to tell me your position or your belief about this issue?

Mr. GENSLER. My position is I would like to work with the Congress on whatever helps get the funding, and so, I don't have a philosophic bias on this.

I believe that just as in the securities field, the transaction volume is so significant that it would end up being a very small fee if the Congress wanted to move forward on it.

Senator DURBIN. Well, let me take a step beyond where conversations have been in the past, and ask you, if you included the OTC market in this user fee, transaction tax, whatever you want to characterize it, what you've said to me is that it is dramatically larger than the marketplaces that we're aware of, the exchanges we're aware of.

And that, do you include that in, when you say it would be a very small fee?

Mr. GENSLER. Oh, absolutely. I think that if the Congress were to work on this, that it would be appropriate, it would be spread across the swaps marketplace if it included futures.

In this \$300 trillion swaps marketplace that we're supposed to oversee, we have a \$300 million budget, so just the arithmetic, that's \$1 of budget request, \$1 of budget for every \$1 million in the swaps market, just to give a sense of the scaling.

Senator DURBIN. What I've said to my colleagues on both sides of the Rotunda is that if we do not adequately finance your agency to keep up with the responsibilities that have been sent your way, and the dramatic increase in the volume of trading in the traditional markets, that there will be growing pressure for some other funding source.

And I hope that we rise to the occasion. I hope that we find the financing and appropriations to meet the President's request in the next fiscal year.

FEAR OF GROWTH

The last question is this: There is always a fear, I've served on the appropriation committees in the House and the Senate that we're giving an agency too much money too fast. And that the net result of it will be waste and bad decisions.

To take your budget of \$200 million and increase it by 50 percent in a 12-month period of time is a pretty daunting assignment. Now, you've said, most of it will go to technology, and I'll let you say for

the record, how much of that is scheduled, that you can see, it's going to happen.

We are just moving along a path we had already created to create the technology that we need. But 40-percent-plus will be in new hires, and that too, is a challenge, to come up with the talent you need in your agency. I have visited your office in Chicago. I have met with your people.

You have some extraordinarily talented people. The folks who would like to get on the floor and kick around Federal employees ought to sit down for 5-minutes with your staffers in Chicago and tell me that they can even comprehend what they do for a living, let alone dismiss it as wasteful bureaucracy.

So tell me about increasing your budget by 50 percent in 1 year, and whether this can be spent in a way that a year later you could come before us and say we saw it coming. We're ready, and will spend it well.

Mr. GENSLER. I thank you for those comments, and I'll pass them on to the staff, particularly in Chicago.

I'm very proud of what they've been able to do. I think we can, but just as you worked with us last year, I think you had been conscious of that and I think it's called 2-year money, as a term of art is not incorrect, but I think that we could work with you.

And, you know, how to ensure that we just didn't waste any taxpayer dollars. I mean, we're not going to put money to work if we can't hire the right people. So to hire 300 people in a year is a significant endeavor.

The sooner we would know it, obviously, the better, if we end up in a process where this is after October and then continuing resolutions, then we have to be realistic that it would probably be best that it's put off into 2013 and 2014.

But I think the sooner we'd know it, we would work with you to make sure we would never waste any taxpayer money.

Senator DURBIN. Thank you, and thanks for your patience. I apologize again for being late, and I know we'll continue to work with you as we prepare the appropriations bills.

We have a deeming resolution that has been filed this week in the Senate by Senator Conrad of the Senate Budget Committee which reflects the statutory bipartisan agreement on spending levels.

There is some difference of opinion between the House and the Senate now as to whether that is going to be the guiding rule or some other effort will be intervening, but I think the Senate is likely to proceed based on this bipartisan law signed by the President.

And I'm hoping that we can move on it on a timely basis to meet your last observation. The later in the process you are given notice, the less time you have to make it work right.

And for your agency, for all those regulated by it, and for the taxpayers of this country, we ought to do our best to avoid that problem. Thank you very much for being here.

Mr. GENSLER. Thank you, Mr. Chairman.

SUBCOMMITTEE RECESS

Senator DURBIN. I'm going to have the subcommittee stand recessed. You may get some written questions. It's infrequent, but if you do, and could reply in a timely way, I'd appreciate it.

Mr. GENSLER. Thank you.

Senator DURBIN. Thanks.

[Whereupon, at 3:53 p.m., Wednesday, March 21, the hearing was concluded, and the subcommittee recessed, to reconvene subject to the call of the Chair.]

**IMPLEMENTING DERIVATIVES REFORM: REDUCING
SYSTEMIC RISK AND IMPROVING MARKET
OVERSIGHT**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE IMPLEMENTATION OF THE NEW DERIVATIVES RULES
AND RESPONSIBILITIES OF THE CFTC AND SEC AS MANDATED
UNDER TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND
CONSUMER PROTECTION ACT

MAY 22, 2012

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.fdsys.gov/>

U.S. GOVERNMENT PRINTING OFFICE

77 866 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512 1800; DC area (202) 512 1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM GARY GENSLER**

Q.1. Chairman Gensler, during the week leading up to the bankruptcy of MF Global, how many times did you brief the other Commissioners on the CFTC's management of the crisis? Please explain.

A.1. During the week of October, 24, 2011, as MFG's financial condition deteriorated, CFTC staff became involved in monitoring the firm's financial condition. During that week, the other Commissioners and I were briefed by Commission staff about ongoing developments, including during the Commission's senior staff briefing on Wednesday and its surveillance meeting on Friday.

Q.2. Chairman Gensler, during the week leading up to the bankruptcy of MF Global, at any time did you indicate to the other Commissioners or CFTC staff that you were concerned about customer assets at MF Global? Please explain.

A.2. Yes. During that week and increasingly over the last weekend of October, I was involved in discussions with other regulators regarding the developments. During some of the calls with regulators on October 29-30 and into the morning of October 31, MFG representatives and representatives of a firm considering facilitating the transfer of MFG customer positions also participated. As of October 28, my understanding from staff at the time was that MFG was not reporting a deficiency, under CFTC regulations, in the customer funds accounts. Given the firm's deteriorating financial condition, however, we requested certain detailed back-up documentation regarding the segregated customer funds under section 4d of the Commodity Exchange Act and secured funds under Part 30 of the Commission's regulations. We pressed for the information over the course of the weekend. Even though the firm had provided some summary information, the firm's failure to provide the requested detailed supporting information was a source of concern to me. My involvement was in furtherance of the CFTC's effort to ensure to the maximum extent possible the protection of customer property that had been entrusted to MFG.

Q.3. Chairman Gensler, in an attempt to justify your MF Global recusal, you stated that you did not want your relationship with MF Global CEO Jon Corzine to "be a distraction."

- Why were you not concerned that your relationship with Mr. Corzine would be a distraction from any previous matter involving MF Global?
- Prior to the MF Global bankruptcy, Mr. Corzine had met with you on matters related to Rule 1.25, which regulates the investment of customer segregated funds. Why did you not recuse yourself from those conversations?

(47)

A.3. In keeping with the consistent advice of our General Counsel and Alternate Designated Ethics Officer, I participate in all rulemakings, including Rule 1.25, as they are matters of general applicability. I was advised by the Commission's General Counsel that I was not required to withdraw from participation. However, as it turned to a specific enforcement matter that could involve not just the company but specific individuals, including Jon Corzine, I informed the General Counsel of my decision on November 3 that I would not participate. My decision was in order to ensure that my participation did not serve as a distraction from the Commission's important duties to locate customer funds and conduct an enforcement matter. Subsequently, I executed a "Statement of Non-Participation" to document my decision.

Q.4. Chairman Gensler, you have stated that you "will not participate in any enforcement-related matters involving MF Global and any matter directly related thereto." This language appears to prohibit you from participating in any of the CFTC's efforts to develop recommendations based on lessons learned from the collapse of MF Global. In your absence, who is leading the CFTC's efforts to develop recommendations based on lessons learned?

A.4. I have tremendous confidence in the ability of my fellow Commissioners and the Commission's dedicated staff to develop appropriate recommendations based on lessons learned. With respect to the matters in which I am not participating, Commissioner Jill Sommers is exercising the Commission's executive and administrative functions that otherwise would be exercised by the Chairman in accordance with section 2(a)(6) of the Commodity Exchange Act. In keeping with the consistent advice of our General Counsel and Alternate Designated Ethics Officer, I participate in all rulemakings, as they are matters of general applicability.

Q.5. Chairman Gensler, in Chairman Schapiro's written testimony from the hearing on May 22, 2012, she said that the SEC will publish an implementation plan for their Dodd-Frank derivatives rules and allow the public to comment on it. Will you commit to publishing the CFTC's implementation plan for the Dodd-Frank derivatives rules and allow the public to comment on it?

A.5. The Commission has taken a number of actions to facilitate implementation of Dodd-Frank regulations. These include:

March 16, 2011—Implementing the Dodd-Frank Act, FIA's Annual International Futures Industry Conference, Boca Raton, Florida. Remarks of Chairman Gary Gensler (as posted on CFTC Web site and including listing of order in which rules might be considered).

April 12, 2011—June 10, 2011—Comment period open (292 written comments filed); Concepts document published as a guide for commenters.

May 2, 2011 and May 3, 2011—CFTC-SEC Staff-led Roundtable Discussion on Dodd-Frank Implementation.

May 4, 2011—Notice published in Federal Register re-opening and extending comment periods (through June 30) in order to "provide interested parties with an additional opportunity to participate in" Dodd-Frank Rulemakings. Also requesting comment on the order in which the Commission should consider final rulemakings.

June 17, 2011—Commission seeks public comment on proposed order to grant exemptive relief from the application of Dodd-Frank Act effective dates.

July 14, 2011—Commission publishes final order providing exemptive relief from effective dates of Dodd-Frank Act provisions in order to facilitate a smooth transition for market participants (expiring on December 30, 2011; extended on Dec. 23, 2011).

September 8, 2011—Outline published of Dodd-Frank Title VII Rules the CFTC May Consider in 2011 and the First Quarter of 2012.

September 8, 2011—The Commission sought public comment on proposed rules specifically to establish schedules to phase in compliance with the swap clearing and trade execution requirement provisions of the Dodd-Frank Act. At that meeting, the Commission also approved a proposed rule to phase in compliance with previously proposed requirements, including the swap trading relationship documentation requirement and the margin requirements for uncleared swaps.

December 23, 2011—Commission publishes amendment to July 14 order extending effective date relief through July 16, 2012.

January 11, 2012—Update of order of consideration of final rules posted on Commission Web site.

July 3, 2012—Commission approves amendment to July 14 order extending effective date relief through December 31, 2012.

July 30, 2012—Final rule published in Federal Register detailed phasing of compliance requirements for swaps subject to mandatory clearing

Individual proposed rules specifically request public comment regarding implementation and sequencing. Examples of such rules include: Reporting, Recordkeeping and Trading Records requirements; Real-Time Public Reporting of Swap Transaction Data; Registration of Swap Dealers and Major Swap Participants; and Protection of Collateral of Counterparties to Uncleared Swaps Commission staff—along with staff from the SEC and other implementing agencies—have conducted a number of roundtables (transcripts available on CFTC.gov):

August 20, 2010—Conflicts of interest in the clearing and listing of swaps

September 14, 2010—Swap Data and Swap Data Repositories

September 15, 2010—Swap Execution Facilities

October 22, 2010—Credit Default Swaps

October 22, 2010—Customer Collateral Protection

December 2, 2010—Disruptive Trading Practices

December 12, 2010—Capital and Margin

June 3, 2011—Protection of Cleared Swaps Customer Collateral

June 8, 2011—Swap Data Recordkeeping and Reporting

June 16, 2011—Definition of Swap Dealer and Major Swap Participant

July 6, 2011—Changes related to Commodity Pool Operators and Commodity Trading Advisors

August 1, 2011—International issues

January 30, 2012—“Available to Trade” Provision for SEFs and DCMs

Feb 29 and March 1, 2012—Roundtables to discuss additional customer collateral protection

May 31, 2012—The Volcker Rule

June 5, 2012—Core Principle 9 for Designated Contract Markets

August 9, 2012—Additional Customer Protections

Q.6. Chairman Gensler, the Dodd-Frank Act includes indemnification provisions that make it difficult, if not impossible, for foreign regulators to obtain information on swap transactions. All five SEC Commissioners support repealing the indemnification requirements. Two CFTC Commissioners agree, saying that the CFTC’s recent interpretive guidance does not fix the problem. Do you agree with the seven SEC and CFTC Commissioners that the indemnification provisions should be repealed?

A.6. The CFTC is working to ensure that both domestic and international regulators have access to swap data to support their regulatory mandates. The CFTC adopted proposed interpretative guidance stating the view that foreign regulators seeking access to swap data repositories will not be subject to the indemnification provisions if the trade repository is regulated by foreign law and the data is reported under foreign law. The CFTC requested public comment on all aspects of the interpretative guidance.

Q.7. Chairman Gensler, the SEC’s swap entity definition rule-making contains a lengthy discussion of how they determined that \$8 billion is the appropriate *de minimis* level to be regulated as a dealer in the derivatives markets they oversee.

- How did the CFTC determine that the same \$8 billion figure is appropriate for the markets that you oversee?
- What credit default swap data did the CFTC use in its analysis?
- What interest rate swap data did the CFTC use in its analysis?
- What commodity swap data did the CFTC use in its analysis?
- What agricultural swap data did the CFTC use in its analysis?

A.7. After reviewing comments received regarding the CFTC and SEC joint proposed rule to further define the terms “swap dealer” and “major swap participant,” the Commissions arrived at the determination that, generally, a \$3 billion notional value in swaps activity over the prior 12 months represented an appropriate *de minimis* threshold. The amount was based on input from commenters and supported by several rationales, including the estimated size of the domestic swap market. Commenters who addressed the question proposed that the standard be set at a level between \$200 million and \$3.5 billion in notional amount entered into over a period of 12 months. Data and other market descriptions were provided through written comments as well as through input in roundtable discussions hosted by staffs of the two Commissions, as well as index CDS data provided by the SEC and data contained in the Quarterly Report on Bank Trading and Derivatives Activities issued by the Office of the Comptroller of the Currency. The Com-

missions also determined it to be appropriate to establish a *de minimis* threshold phase-in period during which higher *de minimis* thresholds would apply. During this phase-in period, the joint final rule provides generally for a *de minimis* level of swap dealing activity over the prior 12 months of a gross notional value of \$8 billion. The Commissions noted particularly that the implementation of swap data reporting under the Dodd-Frank Act may result in new data that would be useful in confirming the Commissions' determination to establish the \$3 billion threshold which applies after the phase-in period.

Q.8. Chairman Gensler, the Depository Trust and Clearing Corporation (DTCC) has made a comprehensive global database of detailed credit default swap transaction and position data available to regulators for more than a year. It is my understanding that all of the financial regulators, except the CFTC, have made use of this data as of the date of the hearing.

- When the press began to report that JP Morgan's London office had taken extremely large positions in credit default swap indexes—which fall under the jurisdiction of the CFTC—why didn't the CFTC immediately begin examining the DTCC data?
- If the CFTC had made use of the DTCC data, would you have had a better line of sight into the JP Morgan trades that are the subject of so much scrutiny?

A.8. The CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's CIO. I am unable to provide any specific information about a pending investigation.

Q.9.-1. Chairman Gensler, according to Mr. Corzine's Congressional testimony, he met with you on May 5, 2010 at the CFTC.

- What issues were discussed at that meeting? Who else was present at that meeting?

Q.9.-2. Chairman Gensler, on November 17, 2010, MF Global submitted a comment letter on a CFTC regulation. Five days later, you were a guest lecturer on Government regulation at Mr. Corzine's class at Princeton University.

- Were any of the issues related to MF Global's comment letter discussed at any time while you were at Princeton, inside of class or outside of class? Please explain.

Q.9.-3. Chairman Gensler, according to Mr. Corzine's Congressional testimony, he met with you in December 2010 at the CFTC.

- What issues were discussed at that meeting? Who else was present at that meeting?

A.9.-1.-3. For the convenience of the Committee, I include a document that will address these questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Insert 1 [Confidential Memorandum follows:]



Office of General Counsel

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
 1155 21st Street, NW, Washington, DC 20581
 Telephone: (202) 418-5120
 Facsimile: (202) 418-5524

INSERT I

CONFIDENTIAL MEMORANDUM

TO: Chairman Gensler

FROM: Dan M. Berkovitz 
 General Counsel and Designated Agency Ethics Official

John P. Dolan 
 Counsel and Alternate Designated Agency Ethics Official

DATE: December 13, 2011

SUBJECT: Participation in Matters Concerning MF Global, Inc.

I. Introduction and Summary

Pursuant to 5 C.F.R. § 2635.502, the Commodity Futures Trading Commission (CFTC or Commission) designated agency ethics official (DAEO) has undertaken this review of the participation of CFTC Chairman Gary Gensler in certain CFTC matters regarding MF Global, Inc. (MFGI), a futures commission merchant (FCM) registered with the CFTC. During the 1980s and 1990s Chairman Gensler and the former President and Chief Executive Officer (CEO) of MFGI, Jon Corzine, worked together and were partners at Goldman Sachs (GS), an investment bank.¹

On November 3, 2011, the General Counsel and DAEO provided Chairman Gensler with an oral opinion that the Chairman was not required to withdraw from participation in MFGI matters as a result of his prior relationship with Mr. Corzine. On that same date Chairman Gensler nonetheless elected to not participate in enforcement matters related to MFGI.² Following this

¹ Mr. Corzine resigned as President and CEO of MFGI on Friday, November 4, 2011.

² On November 8, 2011, Chairman Gensler executed a "Statement of Non-Participation." This statement explained the Chairman's decision: "With respect to the recent matters involving MF Global, the staff at the CFTC is working hard to recover customers' funds and to find out what happened to the missing customer money and how it happened. The CFTC has a tremendously capable staff and I do not want my participation to be in any way a distraction in this important matter."

decision, the General Counsel and DAEO and ADAEO decided to undertake this review to determine whether Chairman Gensler's participation in matters involving MFGI was appropriate.

Based on the facts and circumstances detailed in this memorandum, and based upon the standards set forth in 5 C.F.R. § 2635.502, this review concludes that Chairman Gensler was not required to withdraw from matters involving MFGI. From a legal and ethical perspective, Chairman Gensler's participation in Commission matters involving MFGI was not improper.

II. Factual Background

A. MF Global, Inc.

Subsidiary of MF Global

MF Global is a financial business comprising a holding company, MF Global Holdings Ltd., a Delaware corporation headquartered in New York City, and a variety of subsidiaries located in the United States and other countries.³ One of the subsidiaries is MFGI, which is an FCM registered with the CFTC as well as a securities broker-dealer registered with the SEC.⁴ According to the Annual Report (SEC Form 10-K) filed by MF Global Holdings Ltd. in May 2011, MF Global is a broker in markets for commodities and listed derivatives and a broker-dealer in markets for commodities, fixed income securities, equities, and foreign exchange.⁵

MFGI Bankruptcy

On October 31, 2011, the Securities Investor Protection Corporation (SIPC) filed an application for the entry of a protective order in the U.S. Bankruptcy Court placing MFGI in liquidation under the Securities Investor Protection Act (SIPA). On that same date, "the Commission's Division of Enforcement opened an investigation into whether the Commodity Exchange Act (CEA) or Commission regulations were violated in connection with MFGI, and the Commission [] authorized the Division to issue subpoenas."⁶

In a filing on November 2, the Commission informed the Bankruptcy Court that it "intends to take all appropriate action, within the purview of the Bankruptcy Code and the [CEA], to ensure that customers maximize their recovery of funds and to discover the reason for the shortfall in

³MF Global Holdings Ltd. Form 10-K for fiscal year ended March 31, 2011 at 1, <http://www.sec.gov/Archives/edgar/data/1401106/000119312511145663/d10k.htm> (accessed November 6, 2011); see Disclaimer, MF Global Website, <http://www.mfglobal.com/disclaimer> (accessed November 6, 2011).

⁴Disclaimer, MF Global Website, <http://www.mfglobal.com/disclaimer> (accessed November 6, 2011).

⁵MF Global Holdings Ltd. Form 10-K for fiscal year ended March 31, 2011 at 5, <http://www.sec.gov/Archives/edgar/data/1401106/000119312511145663/d10k.htm> (accessed November 6, 2011).

⁶CFTC Press Release, PR6140-11, November 10, 2011.

segregation.”⁷

Key officials

Jon S. Corzine was the Chairman and Chief Executive Officer of MF Global Holdings Ltd. until his recent resignation.⁸ According to the MF Global website, Mr. Corzine also is an operating partner at J.C. Flowers & Co. LLC.⁹ According to the MF Global website, Mr. Corzine joined GS as a fixed income trader in 1975 and subsequently served as chief financial officer and as chairman and senior partner from 1994 through 1999.¹⁰

Bradley I. Abelow is the President and Chief Operating Officer of MF Global Holdings Ltd.¹¹ According to the MF Global website, Mr. Abelow previously was a partner and managing director of GS, where he managed the operations group.¹² Earlier he was responsible for GS’s operations, technology, risk, and finance functions in Asia.¹³ He joined GS in 1989.¹⁴

Laurie R. Ferber is the General Counsel of MF Global Holdings Ltd.¹⁵ According to the MF Global website, Ms. Ferber worked for GS for over 20 years beginning in 1987.¹⁶ She held a number of different positions including serving as co-general counsel of the Fixed Income,

⁷ Statement of Commodity Futures Trading Commission in Support of the Trustee’s Emergency Motion for an Order Approving the Transfer of Certain Segregated Customer Commodity Accounts of MF Global Inc. and Related Margin and Motion for Expedited Hearing, MFGI Bankruptcy Case, November 2, 2011.

⁸ Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage> (accessed November 6, 2011).

⁹ Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=198970> (accessed November 6, 2011).

¹⁰ *Id.*

¹¹ Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage> (accessed November 6, 2011).

¹² Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=204097> (accessed November 6, 2011).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage> (accessed November 6, 2011).

¹⁶ Executive Officers Biography, MF Global Website, <http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=186545> (accessed November 6, 2011).

Currency and Commodities Division and launching and running the economic derivatives business.¹⁷

J. Christopher Flowers is the founder and executive chairman of J.C. Flowers & Co. LLC, a private equity firm.¹⁸ According to press reports, J.C. Flowers & Co. owns preferred stock in MF Global that, if converted to common stock, would amount to 6% of the total.¹⁹ Also according to press reports, Mr. Flowers worked with Mr. Corzine at GS and later recommended that Mr. Corzine take over as MF Global's chairman and chief executive officer in March 2010.²⁰

B. Relationship Between Chairman Gensler and Mr. Corzine²¹

Chairman Gensler's Employment at GS

Chairman Gensler worked at GS from September 1979 until September 1997, when he left to serve as Assistant Secretary of Treasury for Financial Markets.²² In late 1988, when Chairman Gensler became a partner in the firm, there were approximately 128 partners at GS, including Chairman Gensler and Mr. Corzine.²³

From his arrival at GS in 1979 until late 1991 or early 1992, Chairman Gensler worked in the Mergers and Acquisitions (M&A) Department.²⁴ In late 1991 or early 1992, Chairman Gensler and a few other junior partners at the firm were asked to transfer to other departments as part of their career development. The transfers were suggested by Mr. Robert Rubin (the co-Chairman and Co-Senior Partner of GS at the time) and Mr. Corzine (the co-head of the fixed income department (FI) at the time). Mr. Gensler was asked to transfer to FI and agreed.

Chairman Gensler's initial assignment in FI was in the mortgage trading department. In this capacity, he reported to Michael Mortara, who reported to Mr. Corzine and the other co-head of FI, Mr. Mark Winkelman. Chairman Gensler, Mr. Mortara, and Mr. Corzine all worked on the fixed income trading floor.

¹⁷ *Id.*

¹⁸ J.C. Flowers & Co. LLC: Private Company Information – Business Week, (accessed November 6, 2011) <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=1089967>.

¹⁹ JC Flowers Fund Said to See \$47.8 Million Loss on MF Global – Businessweek (November 2, 2011), <http://www.businessweek.com/news/2011-11-02/jc-flowers-fund-said-to-see-47-8-million-loss-on-mf-global.html> (accessed November 6, 2011).

²⁰ *Id.*

²¹ The facts in this section are based primarily upon an interview with Chairman Gensler conducted on November 4, 2011.

²² Chairman Gensler served as Assistant Secretary for Financial Markets from September 1997 until April 1999, and as Undersecretary of Treasury for Domestic Finance from April 1999 to January 2001.

²³ By 1997, when Chairman Gensler left GS, there were approximately 190-200 partners at GS.

²⁴ Chairman Gensler spent approximately 6-12 months during the 1983-1984 time period on the equity trading floor as part of a "mobility program."

In January 1993, Mr. Corzine requested, and Chairman Gensler agreed, that Chairman Gensler serve as co-head of fixed income trading in the GS office in Tokyo, Japan. Chairman Gensler served in this position until late 1994. During this two-year period, Mr. Corzine and Mr. Winkelman were Chairman Gensler's direct supervisors.

In the fall of 1994, Chairman Gensler was asked by Mr. Steve Friedman, who was then co-head of GS with Mr. Rubin, to transfer out of FI to be the head of the Operations, Technology, and Finance Division (OTF) in Asia. Chairman Gensler reported to Mr. John Thain, head of worldwide OTF. Shortly thereafter, Mr. Corzine became the Senior Partner of GS and Chairman of the Management Committee.²⁵

Chairman Gensler returned to New York in November 1995 to become co-head of Finance. In this position, Chairman Gensler continued to report to Mr. Thain, who continued to report to Mr. Corzine and Mr. Paulson. As co-head of Finance, Chairman Gensler served on various committees of the firm, including the Risk Committee. Mr. Corzine also was a member of the Risk Committee (which had approximately 10-15 members), and sometimes he participated on other committees, too. Chairman Gensler served as co-head of Finance until he left GS in 1997 for the Treasury Department. Prior to leaving GS, Chairman Gensler visited with Mr. Corzine at the latter's apartment to provide departing observations.²⁶

After Chairman Gensler Left GS

To the best of his recollection, Chairman Gensler believes he did not see Mr. Corzine for three years after Chairman Gensler left GS.²⁷ While Chairman Gensler served at Treasury, the only time that he saw Mr. Corzine was in late 2000 or early 2001. Then-Senator-elect Corzine had come to the Treasury Department to visit with Secretary of Treasury Lawrence Summers, and following the meeting with Secretary Summers, Mr. Corzine stopped by to say hello to then-Undersecretary Gensler.

In early 2002, Chairman Gensler volunteered to serve as an advisor to Senator Paul Sarbanes on legislation that eventually was enacted as the Sarbanes-Oxley Act. Senator Sarbanes was Chairman of the Senate Committee on Banking, Housing and Urban Affairs and Senator Corzine was a member of the same Committee. In his role as advisor to Senator Sarbanes, Chairman Gensler occasionally spoke with Senator Corzine about the pending legislation. Chairman Gensler also spoke with Senator Corzine while Chairman Gensler, Senator Sarbanes, and Senator Corzine were on the Senate floor during the consideration of the legislation for final Senate passage.

²⁵ Executive functions were shared between Mr. Corzine and Mr. Henry Paulson, who served as Chief Operating Partner and Vice-Chairman of the Management Committee. Mr. Thain reported to Mr. Corzine and Mr. Paulson.

²⁶ Mr. Corzine subsequently left GS in early 1999.

²⁷ Chairman Gensler believes that he may have spoken with Mr. Corzine once or twice by telephone while serving at Treasury, but cannot specifically recall any such conversations.

In 2003-2004, Chairman Gensler served as Treasurer of the Maryland State Democratic Party. During the same time, Senator Corzine became head of the Democratic Senatorial Campaign Committee. As a result of their fundraising responsibilities, Chairman Gensler saw Senator Corzine at several political events attended by large numbers of people. This included an event to support the campaign of Senator Kerry for President in 2004, which was attended by approximately 400 others, including other members of Congress.

In 2005, Chairman Gensler was invited to a fundraiser in Washington, DC, for the New Jersey State Democratic Party. Approximately 100 people attended, including both Senator Corzine and the other Senator from New Jersey, Senator Frank Lautenberg. At the time, Senator Corzine was campaigning to be elected Governor of New Jersey. As a participant in the fundraiser, Chairman Gensler contributed \$10,000 to the New Jersey State Democratic Party (as he similarly contributed to the State Democratic Party of several other States), which earned him the title of being a "host" of the fundraiser.²⁸ Chairman Gensler did not see Governor Corzine for another three years.

During the primary season for the 2008 Presidential campaign, Chairman Gensler first served as an unpaid senior advisor to the campaign of then-Senator Hilary Clinton. Chairman Gensler recalls speaking with Governor Corzine on a couple of occasions to answer Governor Corzine's questions about Senator Clinton's positions on various policy issues. Chairman Gensler recalls seeing Governor Corzine at a fundraising event in New Jersey in either August or September of 2008 for then-Senator Obama.

Chairman Gensler's Tenure at the CFTC

Chairman Gensler began serving as Chairman of the CFTC in May 2009. At the time he joined the CFTC, Chairman Gensler determined not to participate in any CFTC matters involving GS.

Shortly after joining MFGI in March 2010, Mr. Corzine met with Chairman Gensler and the Chairman's staff at CFTC headquarters. Mr. Corzine requested the meeting, which Chairman Gensler recalls as a "meet and greet" and that Mr. Corzine did not make any specific requests to Chairman Gensler.

In November 2010, Mr. Corzine asked Chairman Gensler to speak at a seminar at Princeton University that Mr. Corzine was conducting on financial institutions and regulation.²⁹ Mr. Andrew Ross Sorkin also spoke at this seminar, and Mr. Corzine introduced both of them. Following the seminar, Chairman Gensler joined Mr. Corzine and approximately 15-20 students for dinner.³⁰ Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while Chairman Gensler was at Princeton.

²⁸ Chairman Gensler's contribution was to the New Jersey State Democratic Party, not directly to Senator Corzine's campaign for Governor.

²⁹ A copy of Chairman's Gensler's speech can be found at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/2010/index.htm>. (last visited Nov. 6, 2011).

³⁰ Mr. Sorkin was unable to stay for the dinner.

In December 2010, Mr. Corzine and Ms. Ferber met with Chairman Gensler and other CFTC staff. Chairman Gensler does not recall the subject of the meeting or the matters discussed.

In June 2011, Chairman Gensler was the keynote speaker at lunch at a conference sponsored by Sandler O'Neill and Partners, an investment banking and broker/dealer firm.³¹ Mr. Corzine was seated at the same table as Chairman Gensler during the lunch. The invitation did not come from Mr. Corzine, and Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while Chairman Gensler was at the conference.

In September 2011, Chairman Gensler and Mr. Corzine were both wedding guests of mutual acquaintances. Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while attending the wedding.

Chairman Gensler has been on two conference calls with Mr. Corzine during his term as Chairman of the CFTC. The first, on July 20, 2011, was a conference call to discuss topics relating to a rulemaking regarding CFTC Rules 1.25 and 30.7.³² Second, Chairman Gensler participated in a series of conference calls with other regulatory authorities and MFGI during the days leading up to the filing of the MFGI bankruptcy proceedings. Chairman Gensler is aware that Mr. Corzine was on the line for at least part of one of these calls, regarding the European bond portfolio.³³ Since becoming Chairman of the CFTC, Chairman Gensler has not had any private telephone conversations with Mr. Corzine.³⁴

Summary

Chairman Gensler worked with Mr. Corzine during the last 6 years of Chairman Gensler's tenure at GS. During two of those years (1993-1994), Chairman Gensler reported directly to co-heads Messrs. Corzine and Winkelman; during the other four years, Mr. Corzine was his second-level supervisor. Their relationship during this period was solely professional. Chairman Gensler and

³¹ The firm regularly sponsors such conferences. See, e.g., <https://register.sandleroneill.com/conferences/> (last visited Nov. 6, 2011).

³² A record of this call can be found at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/dtmeeting_072011_928 (last visited Nov. 7, 2011). In response to media questions as to whether a delay in consideration of this rulemaking showed favoritism to MFGI, Chairman Gensler has stated that he has "been consistent on this rule, and I allowed more time for others to continue to look at it." See Silla Brush, Bloomberg, "MF Global Didn't Get Preferential Treatment, CFTC's Gensler," Nov. 7, 2011.

³³ It is possible that Mr. Corzine was on the line during other portions of these conference calls.

³⁴ On November 8, 2011, BNA reported that Chairman Gensler and Mr. Corzine spoke shortly after Mr. Corzine resigned from his positions at MF Global. See Steven Joyce, BNA, "Gensler Says Recusal Decision Made Days Before Corzine Resignation, Grassley Letter," Nov. 8, 2011. This report is not accurate; the reported conversation between Chairman Gensler and Mr. Corzine did not occur.

Mr. Corzine did not socialize or spend time together apart from their mutual professional activities.³⁵

Since the time they worked together at GS over 14 years ago, Chairman Gensler's contacts with Mr. Corzine have been infrequent. Generally, they have met when they both were present at a function organized by others. Similarly, Chairman Gensler has not socialized with Mr. Corzine after his departure from GS, nor have their families socialized with each other. Chairman Gensler and Mr. Corzine do not correspond with each other; Chairman Gensler does not recall any emails or other electronic communications between himself and Mr. Corzine for at least as far back as ten years. Chairman Gensler does not carry Mr. Corzine's personal phone number in his cell phone directory.

Chairman Gensler and Mr. Corzine have never attended any of each other's major non-professional life-events during the entire time they have known each other. Mr. Corzine did not attend Chairman Gensler's wedding (which occurred while Chairman Gensler was at GS), the bat-mitzvahs of Chairman Gensler's daughters, or the funeral of Chairman Gensler's wife. Similarly, Chairman Gensler did not attend Governor Corzine's inaugural in 2005 or his wedding in 2010.

Chairman Gensler did not ask Mr. Corzine for support of his nomination as CFTC Chairman. He has never contributed directly to any of Mr. Corzine's electoral campaigns. He has raised money for several national Democratic figures, but has never solicited a campaign contribution for Mr. Corzine. Nor does he recall ever soliciting a campaign contribution from Mr. Corzine.

C. Relationship Between Chairman Gensler and Other Former GS Officials Working For or On Behalf Of MFGI³⁶

Certain other current MFGI employees and officials previously worked at GS at the same time as Chairman Gensler. Chairman Gensler's relationship with these individuals is as follows:

Brad Abelow

Mr. Abelow became a partner at GS at around the time that Chairman Gensler was leaving GS. At some point, Mr. Abelow became head of OTF in Asia, the position Chairman Gensler had previously occupied. Chairman Gensler recalls that when he was in OTF he and Mr. Abelow had a "weekly to bi-weekly working relationship."

³⁵ Chairman Gensler recalls one non-professional interaction that indirectly involved Mr. Corzine during his tenure at GS. In 1991, Chairman Gensler learned that Mr. Corzine had registered to run in the New York City Marathon that year. Chairman Gensler recalls that he asked Mr. Corzine's secretary whether Mr. Corzine actually was going to run the marathon. A few weeks later Mr. Corzine's secretary told Chairman Gensler that Mr. Corzine would not run in the race and would not use the number he had been provided. Mr. Corzine's secretary gave Mr. Corzine's number to Mr. Gensler, who then used Mr. Corzine's bib number in the race.

³⁶ The facts in this section are based primarily upon an interview with Chairman Gensler conducted on November 4, 2011.

After leaving GS, Chairman Gensler did not see Mr. Abelow until August or September 2008, at a fundraiser for the Presidential campaign of then-Senator Obama. As previously noted, Governor Corzine also attended this event. At the time, Mr. Abelow was Governor Corzine's Chief of Staff. Chairman Gensler recalls speaking to Mr. Abelow for approximately five to ten minutes at this event.

Chairman Gensler believes it is possible that he may have spoken to Mr. Abelow on one or more occasions in his capacity as Governor Corzine's Chief of Staff to facilitate the discussions with Governor Corzine previously noted during the Presidential primary season prior to the 2008 election. After that, Chairman Gensler did not speak with Mr. Abelow again until one of the multi-party conference calls between regulators and MFGI during the weekend prior to the bankruptcy filing of MFGI.

Chairman Gensler and Mr. Abelow did not have a social relationship apart from their professional relationship at GS.

Christopher Flowers

Chairman Gensler began working with Mr. Flowers in the M&A department at GS upon his arrival at GS in 1979. They worked together in M&A for approximately 12 years—until Chairman Gensler was transferred from M&A to FI. While Chairman Gensler was in the M&A department, he and Mr. Flowers frequently discussed M&A issues and strategies, but Chairman Gensler and Mr. Flowers specialized in different industries and, to the best of his recollection, did not work together on any specific deals.

After Chairman Gensler left GS, Mr. Flowers visited him once at the Treasury Department. Chairman Gensler recalls that as part of this visit they may have had lunch together.

Chairman Gensler does not recall seeing Mr. Flowers in person since that meeting at the Treasury Department. Mr. Flowers called Chairman Gensler twice at the CFTC. With respect to the first call, Chairman Gensler recalls that Mr. Flowers expressed condolences that his wife had passed away, and he provided Chairman Gensler with the name of an individual who was knowledgeable about financial market regulation.³⁷ Mr. Flowers did not ask for any action by Chairman Gensler or the CFTC.

In connection with the MFGI matter, Mr. Flowers called Chairman Gensler on October 31, 2011, before Chairman Gensler arrived at the office. Chairman Gensler returned Mr. Flowers' call after he arrived at the office. Several other CFTC employees were present in Chairman Gensler's office for the call and several individuals were present with Mr. Flowers, including Mr. Goldfield, Henri Steenkamp (Chief Financial Officer) and another MFGI official. The MFGI officials on the call provided the call participants with information regarding MFGI's financial status.

³⁷ Chairman Gensler did not contact that individual and does not recall his or her name.

Chairman Gensler and Mr. Flowers did not have a social relationship apart from their professional relationship at GS.

Laurie Ferber

At the time that Chairman Gensler was in FI at GS, Ms. Ferber was a senior compliance officer/attorney at the firm. Chairman Gensler believes that he may have spoken with Ms. Ferber on one or more compliance matters when he was in FI, but he does not recall anything specific.

After leaving GS, Chairman Gensler did not have any contact with Ms. Ferber until he met with the Board of Directors of the Futures Industry Association (FIA) in September 2010. At the time, Ms. Ferber represented MFGI on the FIA Board of Directors. Ms. Ferber also attended the meeting between Mr. Corzine and CFTC officials, including Chairman Gensler, in December 2010. Ms. Ferber also was on the July 20, 2011, conference call between MFGI officials (including Mr. Corzine) and CFTC officials, including Chairman Gensler, concerning topics relating to a CFTC rulemaking regarding Rules 1.25 and 30.7. Chairman Gensler does not believe that he met or spoke with Ms. Ferber after that, until she participated in one or more multi-party conference calls between MFGI and regulators prior to the bankruptcy filing.

Chairman Gensler and Ms. Ferber did not have a social relationship apart from their professional relationship at GS.

Jacob Goldfield

Chairman Gensler first met Mr. Goldfield in late 1991 or early 1992, after Chairman Gensler began working in FI. Mr. Goldfield also worked in FI, trading options on the government bond desk.

At the time that Chairman Gensler was co-head of fixed income trading in Tokyo, he also had co-supervisory responsibility for the trading of Yen currency swaps conducted in Asia. At the same time, Mr. Goldfield, who was located in New York, had supervisory responsibility for the worldwide GS swap book. Accordingly, Chairman Gensler and Mr. Goldfield had overlapping responsibilities with respect to the GS Yen swap book. Chairman Gensler recalls that he and Mr. Goldfield also later may have served together on the Risk Committee.

Mr. Goldfield visited Chairman Gensler on one occasion at the CFTC. During the consideration of the Dodd-Frank legislation, Mr. Goldfield met with Chairman Gensler and at least one other member of the Chairman's staff. Mr. Goldfield told the Chairman that he was doing good work and if he ever needed anything, to give him a call. Chairman Gensler does not recall any other meetings with Mr. Goldfield since Chairman Gensler left GS.

On October 30, 2011, Mr. Goldfield e-mailed Chairman Gensler to inform him that he was at MF Global "in case there are questions." Mr. Goldfield also informed Mr. Gensler that he had "no financial interest in the company and [was] not looking at it for investment." Mr. Gensler asked Mr. Goldfield whether there were "any observations you wish to pass along?" Mr. Goldfield replied, "Not as of now, I want only to send along novel insights that are useful." Chairman Gensler responded, "Novel and useful. Now those are limiting conditions, though I

would say that most everything you have shared over our long knowing each other has been useful." Mr. Goldfield then stated, "Also want to make sure that I am right before I comment." Chairman Gensler does not recall any further comments or information from Mr. Goldfield.

Mr. Goldfield was present at MFGI during one of the conferences call between MFGI and regulators on October 30, 2011. To the best of his recollection, Mr. Goldfield did not speak on the call. A participant from another regulatory agency who was present at MFGI headquarters in New York and who was on the call relayed to Chairman Gensler during the call that Mr. Goldfield walked by and requested that he say "hello to Gensler."

Mr. Goldfield also was present at MFGI during a conference call between MFGI and regulators on the morning of October 31, 2011.

Chairman Gensler and Mr. Goldfield did not have a social relationship apart from their professional relationship at GS.

III. Legal Standard

The standard for determining whether an employee may participate in a matter affecting the employee's financial interests, or involving persons with whom the employee has or has had a professional, business, economic, or personal relationship, is set forth in 5 C.F.R. § 2635.502.

Specifically, § 2635.502(a) provides:

(a) Consideration of appearances by the employee. Where an employee knows that a particular matter involving specific parties is likely to have a direct and predictable effect on the financial interest of a member of his household, or knows that a person with whom he has a covered relationship is or represents a party to such matter, and where the employee determines that the circumstances would cause a reasonable person with knowledge of the relevant facts to question his impartiality in the matter, the employee should not participate in the matter unless he has informed the agency designee of the appearance problem and received authorization from the agency designee in accordance with paragraph (d) of this section.

(1) In considering whether a relationship would cause a reasonable person to question his impartiality, an employee may seek the assistance of his supervisor, an agency ethics official or the agency designee.

(2) An employee who is concerned that circumstances other than those specifically described in this section would raise a question regarding his impartiality should use the process described in this section to determine whether he should or should not participate in a particular matter.

With respect to a "covered relationship," § 2635.502(b)(iv) provides that an employee has a "covered relationship" with any person "for whom the employee has, *within the last year*, served

as officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee.” (Emphasis added.)³⁸

When the circumstances identified in § 2635.502(a) are not present—i.e., there is no direct and predictable effect on the financial interest of a member of his household, and there is no covered relationship—§ 2635.502(a)(2) provides that the procedures specified in § 2635.502 should still be followed if a question concerning the employee’s impartiality may nevertheless remain.³⁹

³⁸ Section 2635.502(b) provides in full that an employee has a “covered relationship” with:

- (i) A person, other than a prospective employer described in § 2635.603(c), with whom the employee has or seeks a business, contractual or other financial relationship that involves other than a routine consumer transaction;
- (ii) A person who is a member of the employee’s household, or who is a relative with whom the employee has a close personal relationship;
- (iii) A person for whom the employee’s spouse, parent or dependent child is, to the employee’s knowledge, serving or seeking to serve as an officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee;
- (iv) Any person for whom the employee has, within the last year, served as officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee; or
- (v) An organization, other than a political party described in 26 U.S.C. 527(e), in which the employee is an active participant. Participation is active if, for example, it involves service as an official of the organization or in a capacity similar to that of a committee or subcommittee chairperson or spokesperson, or participation in directing the activities of the organization. In other cases, significant time devoted to promoting specific programs of the organization, including coordination of fundraising efforts, is an indication of active participation. Payment of dues or the donation or solicitation of financial support does not, in itself, constitute active participation.

³⁹ Under these circumstances—where no financial interest is affected and no covered relationship exists—the Office of Government Ethics (OGE) does not consider the failure to follow these procedures to be “an ethical lapse”:

OGE has consistently maintained that, although employees are encouraged to use the process provided by section 2635.502(a)(2), “[t]he election not to use that process cannot appropriately be considered to be an ethical lapse.” OGE Informal Advisory Letter, 94 x 10(2); *see also* OGE 97 x 8 (‘obligation’ to follow process where covered relationships involved, but employees ‘encouraged’ to use process in other circumstances); OGE 95 x 5 (‘not required by 5 C.F.R. 2635.502 to use the process described in that section’ where there is no covered relationship with person who is a party or represents a party); OGE 94 x 10(1)(employee may ‘elect’ to use process in section 2635.502(a)(2), but ‘election not to use that process should not be characterized, however, as an ‘ethical lapse’).

"For example," the Office of Government Ethics (OGE) explains, "if an employee believes that a personal friendship, or a professional, social, political or other association not specifically treated as a covered relationship, may raise an appearance question, then the employee should use the section 2635.502 process to resolve the question."³⁹

In this event, under the § 2635.502 process, the threshold determination is to "consider whether the employee's impartiality would reasonably be questioned if the employee were to participate in a particular matter involving specific parties where persons, with certain personal or business relationships with the employee are involved."⁴⁰ If it is determined that the employee's participation would "raise a question in the mind of a reasonable person about his impartiality," the agency's designated ethics official may nonetheless authorize the employee to participate in the matter "based on a determination, made in light of all relevant circumstances, that the interest of the Government in the employee's participation outweighs the concern that a reasonable person may question the integrity of the agency's programs and operations."⁴²

OGE 01 x 8, Impartiality and Romantic Relationships, August 23, 2001. OGE has further indicated that in such circumstances, "even if it were now determined, in hindsight, that a reasonable person with knowledge of the circumstances would question the [person's] impartiality, we cannot say that she violated the impartiality rule." *Id.*

⁴⁰ OGE, Memorandum dated April 26, 1999, from Stephen D. Potts, Director, to Designated Agency Ethics Officials, Regarding Recusal Obligations and Screening Arrangements, 99 x 8. Under section 2635.502(a)(2), an employee may determine not to participate in a matter due to appearance concerns even if that employee's withdrawal is not required. *Id.*

⁴¹ *Id.*; 5 C.F.R. § 2635.502(c).

⁴² 5 C.F.R. § 2635.502(d). This section provides the following factors that may be considered in making this determination:

- (1) The nature of the relationship involved;
- (2) The effect that resolution of the matter would have upon the financial interests of the person involved in the relationship;
- (3) The nature and importance of the employee's role in the matter, including the extent to which the employee is called upon to exercise discretion in the matter;
- (4) The sensitivity of the matter;
- (5) The difficulty of reassigning the matter to another employee; and
- (6) Adjustments that may be made in the employee's duties that would reduce or eliminate the likelihood that a reasonable person would question the employee's impartiality.

IV. Analysis

Is there a financial interest or "covered relationship"?

Neither Chairman Gensler nor any member of his household has a financial interest in MFGI, or in any commodity or security interest held by MFGI. More broadly, neither Chairman Gensler nor any member of his household has any other financial interest that would be predictably or directly affected by a CFTC investigation involving MFGI or associated CFTC actions, including participation in the MFGI bankruptcy proceedings, and the recovery of customer funds. Accordingly, the resolution of the MFGI matter would not have a "direct and predictable" effect upon the financial interests of Chairman Gensler or any member of his household. Chairman Gensler does not have a "covered relationship" with MFGI or any of its employees, officers, directors, or shareholders. Chairman Gensler's partnership with GS, Mr. Corzine, and other partners at GS terminated in 1997, more than 14 years ago. This is far beyond the one-year "cooling off period" provided in § 2635.502(b)(iv) for a person who was a general partner with another person to be considered to have a "covered relationship" with such other person.⁴³

Is there a reasonable basis to question the employee's impartiality?

The sole fact that Chairman Gensler at one time was a business partner with Mr. Corzine, without more, does not constitute a reasonable basis, within the meaning of § 2635.502, to question Chairman Gensler's impartiality with respect to matters relating to MFGI.

Once the one-year cooling-off period has passed, the fact that an employee previously was within a covered relationship with respect to another individual, without more, cannot by itself be the basis to reasonably question an employee's impartiality. To hold otherwise would, in effect, transform the one-year cooling off period into a lifetime prohibition, for in every such instance the covered relationship within the one-year period could be cited as the basis for disqualification beyond the one-year period.⁴⁴

The ethics regulations do not require such a result. To the contrary, the procedures in § 2635.502 clearly contemplate that employees who at one time may have had a covered relationship with respect to another person or entity, but that no longer have such a covered relationship, may participate in a matter involving the person or entity that previously was within the covered relationship.

To constitute a reasonable basis to question Chairman Gensler's impartiality, therefore, there must be some additional indicia of a relationship between Chairman Gensler and Mr. Corzine, GS, or its partners, beyond the factors that would establish a covered relationship—i.e., facts in

⁴³ 5 C.F.R. § 2635.502(b)(iv). As previously noted, OGE has stated that if no financial interest is involved and a covered relationship is not present, a determination not to follow the procedures in § 2635.502—and hence to participate in the matter—cannot be considered to be an "ethical lapse." Nonetheless, in accordance with OGE recommendations, Chairman Gensler has determined to follow the § 2635.502 process.

⁴⁴ This conclusion is consistent with the OGE position that in circumstances in which no financial interest is involved and a covered relationship is not present, a determination not to follow the procedures in § 2635.502 cannot be considered to be an "ethical lapse."

addition to Chairman Gensler's partnership at GS some 14 years ago. However, the facts regarding Chairman Gensler's relationship with Mr. Corzine and others at GS who are now associated with MFGI – both during the time that Chairman Gensler worked at GS and afterwards -- are insufficient to provide such indicia.

The record set forth above indicates that at all times, both during their partnership and afterwards, the relationship between Chairman Gensler and Mr. Corzine was exclusively a professional relationship. Chairman Gensler and Mr. Corzine did not socialize or meet apart from their professional obligations and interests. The record indicates that since Chairman Gensler and Mr. Corzine left GS in the late 1990s, they have met only infrequently and solely on matters of mutual professional interest. Indeed, most of their encounters have occurred when they both have been invited to attend an event by others. Although both Chairman Gensler and Mr. Corzine have been involved in political fundraising and electoral campaigning, neither has done so on the other's behalf or at the other's request. They have not socialized, and they have not been involved in each other's personal lives. Their infrequent professional contacts, over a 14-year period following their departure from their partnership at GS, do not constitute a covered relationship or a similar type of relationship that would form a reasonable basis under section 2635.502 to question Chairman Gensler's impartiality with respect to MFGI.⁴⁵

Following his departure from GS, Chairman Gensler's contacts with Mr. Abelow, Mr. Flowers, Ms. Ferber, and Mr. Goldfield have been more attenuated than his contacts with Mr. Corzine. Based on the highly infrequent nature of Chairman Gensler's contacts with these individuals since he left the GS partnership in 1997, Chairman Gensler's relationships with these individuals, both individually and collectively, are insufficient to constitute a reasonable basis under section 2635.502 to question Chairman Gensler's impartiality with respect to MFGI.

In sum, this review determines, based on the facts and circumstances stated herein, that there is not a reasonable basis under 5 C.F.R. § 2635.502 to question Chairman Gensler's impartiality with respect to the Commission's investigation of MFGI and involvement in related matters, such as the MFGI bankruptcy proceedings. Accordingly, 5 C.F.R. § 2635.502 does not preclude Chairman Gensler's participation in these matters, and Chairman Gensler is not required to withdraw from participation. From a legal and ethical perspective, Chairman Gensler's participation in Commission matters involving MFGI would not be improper.⁴⁶

⁴⁵ Chairman Gensler's contribution to the New Jersey State Democratic Party at the time Mr. Corzine was campaigning for Governor of New Jersey is not sufficient to warrant a different conclusion. During this time period, Chairman Gensler was an active fundraiser for and contributor to Democratic candidates for elected office in many states. Chairman Gensler's contribution to the New Jersey State Democratic Party therefore is not sufficient to establish a special relationship between Chairman Gensler and Mr. Corzine that would warrant a different conclusion.

⁴⁶ This review solely addresses matters before the Commission prior to and at the time of the Chairman's election not to participate and is based on the facts contained herein.

Q.10. Chairman Gensler, according to a March 1, 2011 MF Global filing at the Securities and Exchange Commission (SEC), the compensation committee of MF Global's board "believes that Mr. Corzine's leadership improved posture with regulators."

How did MF Global's posture improve with the CFTC under Mr. Corzine's leadership?

A.10. I have no information regarding the basis of the statement in the filing.

Q.11.-1. Chairman Gensler, according to Mr. Corzine's Congressional testimony, you gave a luncheon speech at a conference sponsored by the investment firm of Sandler & O'Neill on June 9, 2011. During the question and answer session, Mr. Corzine asked you about proposed changes to Rule 1.25.

- What specific question did he ask? What was your answer?
- Did you have any other discussions about Rule 1.25 with Mr. Corzine?

Q.11.-2. According to a memo posted on the CFTC's Web site, on July 20, 2011, Mr. Corzine called you regarding Rule 1.25. Discussion included "MMMFs, asset-backed and issuer-based concentration limits, counterparty concentration limits, in-house transactions and repurchase agreements with affiliates."

- Please provide more details about the discussion.
- Who else participated on the call?

A.11.-1.-2. For the convenience of the Committee, I include a document (Insert 1 previously referenced) that will address a number of questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Q.12. Chairman Gensler, according to Mr. Corzine's Congressional testimony, you and Mr. Corzine attended a wedding celebration of mutual friends on September 14, 2011.

Please provide the details of any discussions you had with Mr. Corzine regarding MF Global or CFTC regulation while attending that wedding celebration.

A.12. For the convenience of the Committee, I include a document (Insert 1 previously referenced) that will address a number of questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Q.13.-1. Chairman Gensler, when did you first learn that Moody's had downgraded MF Global on October 24, 2011? What specific actions did you take based upon the downgrade?

Q.13.-2. Did you have direct conversation, or were you part of conversations, with any firms that were considering buying part or all of MF Global's business over the weekend of October 29, 2011 and October 30, 2011? If so, what was the nature of those conversations, and who was involved?

Q.13.-3. Please provide details (including dates, times, and topics discussed) of the communications (*e.g.*, phone calls, emails, text messages, *etc.*) you had with Jon Corzine, or any of his agents or representatives, or any senior members of MF Global, or any of their agents or representatives, from October 24, 2011 through November 1, 2011.

A.13.-1.-3. During the week of October 24, 2011, as MFG's financial condition deteriorated, CFTC staff became involved in monitoring the firm's financial condition. During that week, the other Commissioners and I were briefed by Commission staff about ongoing developments, including that the firm had been downgraded by Moody's. During that week and increasingly over the last weekend of October, I was involved in discussions with other regulators regarding the developments. During a call with regulators on the evening of October 30, representatives of a firm, Interactive Brokers, considering facilitating the transfer of MFG customer positions also participated. My involvement was in furtherance of the CFTC's effort to ensure to the maximum extent possible the protection of customer property that had been entrusted to MFG. Though it was not always apparent which representatives from MFG were present on calls with regulators over the weekend of October 29-30 and into the morning of October 31, to the best of my knowledge and recollection, Mr. Corzine was on the line for at least part of one of these calls, and discussed matters regarding MFG's European bond positions.

Q.14. Chairman Gensler, over the weekend of October 29, 2011 and October 30, 2011, MF Global employees were trying to reconcile a \$900 million under segregation figure. When did you first learn about it?

A.14. I first learned in the early morning hours of October 31, 2011, that the firm was reporting a shortfall in the segregated accounts under section 4d of the Commodity Exchange Act.

Q.15. Chairman Schapiro and Chairman Gensler, under your management, the SEC and the CFTC have been in violation of the law for failing to meet 73 statutory deadlines for rulemaking set by Dodd-Frank.

Can you assure this Committee that your agencies will be in compliance with all applicable Dodd-Frank deadlines that are due by the end of this year? If not, please explain why your agencies are missing so many statutory deadlines.

A.15. The Dodd-Frank Act had a deadline of 360 days after enactment for completion of the bulk of our rulemakings—July 16, 2011. Both the Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. This flexibility has allowed us to approach the rulemaking process thoughtfully—not against the clock. We have coordinated closely with the SEC on these issues. Last year, the CFTC granted temporary relief from certain provisions that would otherwise have applied to swaps or swap dealers on July 16, 2011. The Commission has extended that relief to accommodate its implementation schedule.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM CFTC STAFF**

Q.1. As I mentioned at the hearing, according to the CME's timeline, a CFTC employee gave two CME employees a disc containing documents to support the October 26, 2011 segregated funds statement on the evening of October 30.

- When did the CFTC receive the disc from MF Global?
- When did the CFTC begin reviewing the documents on the disc?
- What was the result of the review of these documents? Did it show any shortfall?
- What specific actions did the CFTC take after reviewing the documents?
- Could you provide the Committee with copies of the documents on the disc?

A.1. At some point after 5 p.m. CDT, and possibly at approximately 5:30 p.m. CDT, on October 28, 2011, MF Global gave a CFTC employee three computer discs. Staff did not at that time undertake a comprehensive review of the discs. A subsequent review of a larger set of records including the information on the discs reflected a shortfall in the customer segregated funds as of Wednesday October 26, 2011.

Q.2. The CFTC had staff onsite at MF Global's Chicago offices the weekend before the firm's bankruptcy filing.

- What specific steps did your agency take to protect customer assets prior to learning that customer assets were missing?
- What date and time did CFTC staff first learn that there was a possible shortfall in the customer segregated accounts? How did the CFTC staff learn about the possible shortfall?
- What date and time did CFTC staff first learn that there was a definite shortfall in the customer segregated accounts? How did the CFTC staff learn about definite shortfall?
- After you learned of the missing customer assets, what specific steps did your staff take to ensure that additional customer funds were not improperly transferred?

A.2. Between 2 p.m. and 2:30 p.m. CDT, Sunday October 30, 2011, a CFTC employee and MF Global employee had a brief conversation from which the CFTC employee understood there was a deficiency or discrepancy in the segregated account. On October 31, the Securities Investors Protection Corporation with the support of the CFTC and the consent of MF Global initiated a liquidation proceeding under the Securities Investors Protection Act of 1970 (SIPA) to protect the customers of MF Global. In FCM bankruptcies, commodity customers have, pursuant to section 766(h) of the Bankruptcy Code, priority in customer property. If customer property is insufficient to satisfy in full all the claims of customers, Part 190 of the Commission's regulations allows other property of the debtor's estate to be classified as customer property to make up any shortfall.

Q.3. Who is responsible for the protection of commodity customer funds at a futures commission merchant (FCM)?

A.3. Under the Commodity Exchange Act, an FCM must treat all money, securities and property received from a customer as margin for the trades or contracts of that customer as belonging to that customer. Furthermore, all customer money, securities, and property must be separately accounted for and segregated from the FCM's proprietary funds. The FCM cannot use funds deposited by one customer to margin or secure trades for another customer. Commission Regulation 1.20 requires that accounts holding segregated funds be titled specifically to identify the contents of the account as separate from the ownership of the FCM. In addition, FCMs must obtain letters from their depositories acknowledging that the funds deposited in those accounts are customer funds and must be treated as such under the CEA—*i.e.*, such depositories are prohibited from treating them as belonging to the FCM or any person other than the customer. Commission Regulation 1.12 requires FCMs to notify the Commission immediately of any occurrence of under-segregation.

Q.4. As I mentioned at the hearing, according to the CME's timeline, a CFTC employee gave two CME employees a disc containing documents to support the October 26, 2011 segregated funds statement on the evening of October 30.

- When did the CFTC receive the disc from MF Global?
- When did the CFTC begin reviewing the documents on the disc?
- What was the result of the review of these documents? Did it show any shortfall?
- What specific actions did the CFTC take after reviewing the documents?
- Could you provide the Committee with copies of the documents on the disc?

A.4. At some point after 5 p.m. CDT, and possibly at approximately 5:30 p.m. CDT, on October 28, 2011, MF Global gave a CFTC employee three computer discs. Staff did not at that time undertake a comprehensive review of the discs. A subsequent review of a larger set of records including the information on the discs reflected a shortfall in the customer segregated funds as of Wednesday October 26, 2011.

Q.5. What authorities does the CFTC have to protect customer segregated accounts at a futures commission merchant (FCM) during an emergency situation?

A.5. An FCM is required to hold sufficient funds in segregated accounts to meet the aggregate total account balances of each of the FCM's customers trading on designated contract markets. When the firm does not hold sufficient funds in segregation to meet the account balances of each of its customers, the Commission can initiate an enforcement action to freeze the customer segregated accounts at the FCM to prevent the FCM from removing funds without appropriate court approvals. If the FCM also is undercapitalized, Commission Regulation 1.17 provides that the FCM must

transfer customer accounts to another FCM, and cease operating as an FCM. If the FCM can immediately demonstrate to the satisfaction of the Commission that it has the ability to come back into compliance with the minimum capital requirements, the Commission may grant the FCM up to a maximum of 10 business days to achieve compliance without having to transfer customer accounts. It is often preferred in an emergency situation to transfer customer accounts and margin funds from the failing FCM to a financially sound FCM. The transfer of the customer accounts and margin funds may pose less of a disruption to customers than a court order freezing customer accounts.

Q.6. In May 2011, FINRA determined that MF Global had a capital deficiency. MF Global CEO Jon Corzine personally appealed that decision to the SEC. The SEC upheld FINRA's determination and MF Global publicly reported the deficiency in August 2011.

- When did the CFTC first learn that MF Global had a capital deficiency? How did the CFTC learn about it?
- In your view, how effective was the SEC's and CFTC's coordination of the regulation of MF Global?

A.6. The CFTC learned that MF Global had a capital deficiency in or about late August 2011. In particular, MF Global submitted a letter to the Commission dated August 25, 2011 stating that on August 24, 2011 FINRA had advised the firm that its capital treatment of certain repo to maturity transactions should be modified resulting in increased capital requirements under SEC Rule 15c3-1. The letter further stated that the firm had increased its capital prior to being advised of the increased capital requirement by FINRA, and that its excess net capital on August 24, 2011 was approximately \$113 million after giving effect to the additional capital requirements for the repo to maturity transactions. By letter dated August 30, 2011, and received by the Commission on August 31, 2011, MF Global stated that on August 29, 2011, FINRA had directed the firm to restate its July 2011 FOCUS Report with the revised capital treatment for the repo to maturity transaction. The restated FOCUS Report was filed with the Commission on August 31, 2011 and showed MF Global to be undercapitalized at the end of July 2011.

Q.7. In December 2009, MF Global settled an enforcement action with the CFTC arising from multiple risk supervision failures.

- Following that enforcement action, what specific steps did you take to ensure that MF Global customer assets were not at risk of being misappropriated?

A.7. The Commission's order imposed a \$10 million civil monetary penalty and required MF Global to comply with several undertakings, including enacting policies and procedures to enhance risk monitoring procedures, training, compliance procedures and compliance audit procedures. MF Global was also required to undertake an independent review and assessment. The assessment, among other things, was to review the effectiveness of existing and future risk management, supervisory and compliance policies and procedure at MF Global.

Q.8. MF Global filed its 10-K for the fiscal year ended March 31, 2011, disclosing detailed information about its exposure to European sovereign debt in its repo-to-maturity portfolio. What specific actions did the CFTC take based upon the information contained in MF Global's 10-K?

A.8. MF Global was placed on heightened financial surveillance in March 2008 by its designated self-regulatory organization, the CME. The heightened financial surveillance required MF Global to provide the CME, on a daily basis, with a net capital computation and computations demonstrating its compliance with its obligation to segregate customer funds under Section 4d of the Commodity Exchange Act and to set-aside customer funds for trading on non-U.S. contract markets under CFTC Regulation 30.7. MF Global also filed copies of its daily capital and customer funds calculations with the CFTC. Staff of the CME and CFTC reviewed the daily submissions to assess MF Global's compliance with the CFTC's capital and customer funds protection requirements.

Q.9. On August 31, 2011, MF Global amended its FOCUS report for July to report a capital deficiency of \$150 million as of July 31, 2011. What specific actions did the CFTC take based upon the amended FOCUS report?

A.9. The CFTC learned that MF Global had a capital deficiency in or about late August 2011. In particular, MF Global submitted a letter to the Commission dated August 25, 2011 stating that on August 24, 2011 FINRA had advised the firm that its capital treatment of certain repo to maturity transactions should be modified resulting in increased capital requirements under SEC Rule 15c3-1. The letter further stated that the firm had increased its capital prior to being advised of the increased capital requirement by FINRA, and that its excess net capital on August 24, 2011 was approximately \$113 million after giving effect to the additional capital requirements for the repo to maturity transactions. By letter dated August 30, 2011, and received by the Commission on August 31, 2011, MF Global stated that on August 29, 2011, FINRA had directed the firm to restate its July 2011 FOCUS Report with the revised capital treatment for the repo to maturity transaction. The restated FOCUS Report was filed with the Commission on August 31, 2011 and showed MF Global to be undercapitalized at the end of July 2011.

Q.10. Please provide the details regarding any discussions of MF Global at any of the Intermarket Financial Surveillance Group's (IFSG's) meetings or calls in 2011, including IFSG's annual meeting on October 19, 2011.

A.10. The IFSG is comprised of securities and futures self-regulatory organizations. Though the CFTC is not a member, CFTC staff did attend the meeting on October 19, 2011. The SEC and FINRA led the discussion of the topic of European sovereign debt and the potential impact on broker-dealers. FINRA discussed how it had reviewed the largest broker-dealers and did not identify any material exposures to European sovereign debt with the exception of MF Global. The SEC also had reviewed the broker-dealers for exposure to foreign sovereign debt, and noted no major concerns (other than MF Global). FINRA also discussed how FINRA and the

SEC had required MF Global to take additional capital charges on its European sovereign debt positions. The capital charges were retroactive to the end of July 2011. MF Global increased its capital in August, when informed of the capital charges. The retroactive application of the charges to the end of July 2011, however, caused MF Global to be undercapitalized as of the end of July 2011. FINRA discussed how it was going to continue to monitor broker-dealer exposure to foreign sovereign debt on an ongoing basis.

Q.11. When did you first learn that MF Global had retained Evercore to explore selling its FCM business? When did you first learn that MF Global had instructed Evercore to explore selling the entire firm?

A.11. CFTC staff do not recall any direct interaction with Evercore partners. However, often in the case of a failing FCM, a preferred option is to accomplish the transfer of customer accounts and margin funds from the failing firm to a financially sound FCM. Such a transfer would normally pose less of a disruption to customers.

Q.12. Over the weekend of October 29, 2011 and October 30, 2011, MF Global employees were trying to reconcile a \$900 million under segregation figure. When did CFTC staff first learn about this reconciliation?

A.12. Between 2 p.m. and 2:30 p.m. CDT, Sunday October 30, 2011, a CFTC employee and MF Global employee had a brief conversation from which the CFTC employee understood there was a deficiency or discrepancy in the segregated account.

Q.13. What CFTC staff members were onsite at MF Global on each of the following days?

- Monday, October 24, 2011
- Tuesday, October 25, 2011
- Wednesday, October 26, 2011
- Thursday, October 27, 2011
- Friday, October 28, 2011
- Saturday, October 29, 2011
- Sunday, October 30, 2011
- Monday, October 31, 2011

A.13. Roughly, up to seven CFTC staff members were present at various times at MF Global's offices in Chicago and New York from October 27 to October 30, 2011.

**DODD-FRANK WALL STREET REFORM
AND CONSUMER PROTECTION ACT:
2 YEARS LATER**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS
SECOND SESSION

—————
JULY 17, 2012
—————

Printed for the use of the
Committee on Agriculture, Nutrition and Forestry



Available via the World Wide Web: <http://www.fdsys.gov/>

U.S. GOVERNMENT PRINTING OFFICE

78-275 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

Chairwoman Debbie Stabenow

1) The advent and adoption of high-frequency and algorithmic trading seems to have had a dramatic impact on the way markets operate. Have you defined this kind of trading? Have you analyzed closely the impact of this trading on markets? Do regulators have enough information to assess that impact? If so, what is that impact?

Response: The Commission has undertaken several initiatives in response to the increased speed and automation in the markets, including automated trading systems (ATSs) that use high-frequency trading strategies. Commission staff are developing a recommended concept release on market safeguards that will address a number of pre-trade risk controls, post-trade reports and system safeguards for exchanges and market participants. The measures considered in the concept release would be designed to reduce the risk of market disruption arising from erroneous orders and trades, improve the testing and supervision of ATS, and respond to the increased speed and automation of futures markets. The concept release will seek public comment to inform the Commission regarding next steps.

The Commission also is researching possible methods of better identifying trading algorithms in the regulatory trade data provided by exchanges to the Commission daily. Staffing goals for both the implementation of the Dodd-Frank Act and conducting pre-Dodd-Frank mandates include hiring new staff that possesses broad skills in data management and data analysis. Such staff would be used to surveil trading of ATSs and high-frequency traders.

2) Mr. Erickson raised concerns in his testimony that some commercial entities on both the buy and sell sides in certain energy and agricultural markets may be captured by the swap dealer definition. Given their lack of experience with regulation, they might opt to leave the market. He states in his testimony: "There will be a drying up of liquidity, particularly in smaller, more esoteric markets where the profit margins are not there for the large banks and the only entities willing to trade are those with physical market risk. By regulating these entities as Swap Dealers, the cost of hedging in the commercial space will go up." Do you share this concern?

In December 2010, the CFTC (jointly with the SEC) issued a proposed rulemaking to further define the term "swap dealer." The proposal noted that the Dodd-Frank Act defines a swap dealer in terms of whether a person engages in certain types of activities involving swaps. Specifically, the statutory definition encompasses an entity that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for its own account, or is commonly known in the trade as a dealer or market maker in swaps.

Senate Agriculture Committee Hearing
Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
Tuesday, July 17, 2012
Questions for the Record
Responses of CFTC Chairman Gary Gensler

The Dodd-Frank Act directs that the Commission exempt from the definition any entity that engages in a *de minimis* quantity of swap dealing. The proposed joint rule included a description of the factors and thresholds proposed to be used for determining the *de minimis* exemption to the swap dealer definition, and specifically requested that the public provide comments. Many commenters that responded to the proposal addressed the factors and thresholds that should be applied, as well as the application of the swap dealer definition. The Commission specifically requested that commenters provide detailed information related to the costs of compliance with related rulemakings.

On April 18, 2012, the Commissions acted to approve the final joint rule to further define the term "swap dealer." The number of entities required to register is uncertain and will depend on the decisions of businesses involved. The rule generally provides that a person shall not be deemed a swap dealer if its swap dealing activity over the preceding 12 months results in swap positions with an aggregate gross notional amount of no more than \$3 billion (the joint proposed rule included a threshold of \$100 million). The rule also provides for a phase-in of the *de minimis* threshold to facilitate orderly implementation of swap dealer requirements. During the phase-in period, the *de minimis* threshold is effectively \$8 billion.

True to congressional intent, end-users other than those genuinely making markets in swaps won't be required to register as swap dealers. The swap dealer definition benefited from the many comments from end-users who use swaps to hedge their risk.

Ranking Member Pat Roberts

1) We understand that some time ago the CFTC's inspector general was asked to issue a report reviewing the MF Global matter. Please advise this committee as to whether that report has been issued and if so, why not?

Response: The Office of the Inspector General has been asked to respond directly.

2) Please submit to the committee CFTC's budgeted (beginning of the year) and actual object class breakdown for salaries and expenses for each of the past five fiscal years (2007 to 2011).

Insert 1

INSERT 1

| Object Class Category | FY 2007 | | | FY 2008 | | | FY 2009 | | | FY 2010 | | | FY 2011 | | |
|---|----------------|----------------|------------|----------------|----------------|------------|----------------|----------------|------------|----------------|----------------|------------|----------------|---------------------|------------|
| | Budget (\$000) | Actual (\$000) | Difference | Budget (\$000) | Est. Actual (\$000) | Difference |
| 11 1 11 6 Personnel Compensation | 57,493 | 55,536 | 1,957 | 66,507 | 67,793 | 2,554 | 75,727 | 66,603 | 9,126 | 63,857 | 82,577 | 11,780 | 95,426 | 95,910 | (495) |
| 12 1 Personnel Benefits-Civilian | 14,807 | 13,891 | 906 | 15,884 | 14,906 | 1,488 | 20,450 | 17,086 | 3,357 | 25,183 | 23,264 | 2,629 | 27,898 | 27,336 | 562 |
| 13 0 Retirees/Former Employees | 34 | 9 | 25 | 9 | 0 | 9 | 8 | 0 | 8 | 0 | 4 | 5 | 1 | 0 | 1 |
| 21 0 Travel & Transportation of Persons | 3,412 | 3,345 | 766 | 3,395 | 1,418 | (1,771) | 3,571 | 2,029 | (4,581) | 2,334 | 1,959 | 345 | 2,167 | 1,319 | 843 |
| 22 0 Transportation of Things | 68 | 48 | 40 | 88 | 37 | 51 | 200 | 82 | 118 | 108 | 55 | 45 | 21 | 76 | 141 |
| 24 7 Rental Payments to Others | 11,878 | 11,947 | (64) | 12,635 | 11,610 | 1,095 | 4,429 | 13,077 | (8,648) | 13,311 | 13,652 | (341) | 16,540 | 17,610 | (1,061) |
| 24 8 Comm. Utilities & Miscellaneous | 2,716 | 2,362 | 354 | 2,857 | 2,049 | 484 | 13,079 | 1,676 | 9,403 | 1,967 | 4,156 | (1,941) | 4,734 | 4,852 | (646) |
| 24 0 Printing & Reproduction | 401 | 916 | 85 | 406 | 312 | 88 | 477 | 340 | 132 | 377 | 664 | (317) | 1,539 | 1,862 | (323) |
| 25 0 Other Services | 7,374 | 13,086 | (1,712) | 13,144 | 16,705 | (1,561) | 21,304 | 23,153 | (1,852) | 25,381 | 36,920 | (5,229) | 43,577 | 47,209 | (1,682) |
| 26 0 Supplies & Materials | 826 | 731 | 85 | 830 | 749 | 81 | 1,010 | 1,323 | (13) | 1,012 | 1,055 | (43) | 1,254 | 1,186 | 74 |
| 31 0 Equipment | 887 | 541 | 346 | 5,390 | 5,549 | (159) | 6,848 | 12,216 | (6,067) | 3,181 | 7,827 | (4,291) | 7,176 | 8,803 | (1,623) |
| 32 0 Buildings/Fixed Equipment | 66 | 10 | 56 | 51 | 60 | (15) | 1,306 | 5,785 | (4,773) | 389 | 3,885 | (3,307) | 2,500 | 0 | 2,500 |
| 42 0 Current/Daycare | 0 | 0 | - | 76 | 2 | 73 | 0 | 0 | 0 | 0 | 25 | (25) | 0 | 0 | 0 |
| 99 0 Total Obligations | 97,881 | 97,567 | 414 | 113,766 | 113,166 | 100 | 146,000 | 145,783 | 217 | 168,800 | 168,348 | 452 | 202,270 | 202,170 | 100 |

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

3) The CFTC's final position limits rule will be effective 60 days after the recently approved final rule defining the term "swap" is published in the Federal Register. However, the position limits rule is the subject of ongoing litigation. Will the CFTC require market participants to comply with the final position limits rule before the case has been adjudicated?

Response: The U.S. District Court for the District of Columbia issued an order vacating the final rule and remanding it to the Commission.

4) The position limits rule requires monthly reporting of daily cash positions when parties exceed the position limits. Is the CFTC willing to consider a "commercial reasonableness" standard to these submissions since many of the submitting companies have global operations whose products are in commerce around the clock and for which systems to track and monitor inventories to this degree may be difficult to implement within the 60 day window provided?

5) Would the CFTC consider implementing such a standard by rulemaking on its own or through an industry petition?

Response to questions 4 and 5: The Commission received a petition dated September 11, 2012, related to the reporting of daily cash positions. In response to the petition and questions from industry participants related to the implementation of Federal position limits, Commission staff has begun to develop appropriate guidance. The U.S. District Court for the District of Columbia issued an order vacating the final rule and remanding it to the Commission.

6) At the hearing you said that avoiding a cost benefit analysis was not one of your reasons for implementing your cross border/extraterritoriality rule as an "interpretative guidance" as opposed to pursuant to a formal rulemaking. Would you be willing to voluntarily undertake a cost-benefit analysis?

Response: Section 722(d) of the Dodd-Frank Act states that swaps reforms shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States." The Commission has received numerous requests from market participants with regard to the interpretation of this provision.

The Commission, consulting closely with the SEC, the Federal Reserve and the Treasury Department, issued proposed guidance interpreting this section of the law. The Commission also proposed in a separate release phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) of certain requirements of Dodd-Frank swaps market reform. Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion and allow time for the CFTC to receive and evaluate public comment on the cross-border interpretive guidance. The Commission's Global Markets Advisory Committee also addressed these matters in a

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

recent public meeting. The Commission looks forward to reviewing all comments submitted including those related to costs.

The Commission takes very seriously the consideration of costs and benefits of the rules it considers under the Dodd-Frank Act as required under section 15(a) of the Commodity Exchange Act. The economic costs and benefits associated with regulations, especially as they pertain to commenters' concerns, are of utmost importance in the Commission's deliberation and determination of final rules. For rules implementing Dodd-Frank reform, as well as the Commission's proposed interpretive guidance, the requirements of section 15(a) were applied.

Senator Tom Harkin

Accountability of Self-Regulatory Organizations

It is my understanding that a futures commission merchant does not have to carry a bond or insurance to protect its customers against losses, such as from fraud or malfeasance. An insurer or bond issuer would have a financial stake to protect and should therefore be strongly motivated to scrutinize very carefully the integrity, performance, and behavior of the firm whose obligations it is insuring or guaranteeing.

1) What does the National Futures Association and other futures industry self-regulators have at stake, financially or otherwise, in their oversight and enforcement of rules with respect to futures commission merchants, brokers, and other futures industry participants?

Response: Self-regulatory organizations (SROs) have specific obligations to ensure that futures commission merchants (FCMs) protect customers and their funds, and adhere to Commission and SRO regulations. Generally, the National Futures Association (NFA) performs the financial surveillance of FCMs that are not direct clearing members of a derivatives clearing organization (DCO) and clearinghouse SROs perform the financial surveillance of FCMs that are clearing member firms of a DCO.

The Commission oversees the SROs (both NFA and SROs that are part of designated contract markets (DCMs)) and has the authority to discipline, suspend or revoke an SRO's registration. This oversight serves as an important check. The entire purpose of the NFA is to help ensure that the markets are fair, efficient and safe for all participants. The Commission works with SROs and market participants in an effort to find the best methods to govern the futures markets in way that protects customers and instills confidence.

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

Exchanges and DCOs have a direct financial stake in ensuring that the clearing member-FCMs do not experience financial losses from market events or other factors, including the misappropriation of funds, in proprietary or customer accounts. Such losses at an FCM that exceed the FCM's capital and other financial resources may present a financial risk to the DCOs.

The Commission has recently issued proposed rules to enhance the protections afforded customers that participate in the futures and swaps markets, including the protection of customer funds held by futures commission merchants and derivatives clearing organizations. The Commission looks forward to reviewing public comment on these important initiatives.

2) Does the CFTC have enough power and authority to ensure that industry self-regulatory organizations fulfill their responsibilities?

Response: The CFTC has comprehensive authority to oversee SRO functions and to bring disciplinary actions. The Commission's authority related to SROs include:

- Requirement that FCMs and other intermediaries be registered with the NFA;
- Requirements that the SRO demonstrate that, in regulating the practices of its members, it will require adherence to regulatory requirements;
- Commission authority to abrogate association rules or to request that the futures association alter or supplement its rules;
- Requirement that the SROs police their members for fraud and misconduct and ensure compliance with requirements related to minimum capital levels and the segregation of customer funds; and
- Commission authority to suspend or revoke the registration of any registered futures association.

An adequately funded CFTC is a good investment for the American public and would further ensure the integrity of markets.

Proposals for an Insurance Fund to Protect Futures Customers

It has been suggested that there perhaps ought to be an insurance fund for the protection of futures customers analogous to the Federal Deposit Insurance Corporation for bank depositors and the Securities Investor Protection Corporation for securities customers.

3) What are the main considerations and perspectives that in your view should go into judging whether such insurance should be established for futures customers?

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

4) Has the CFTC examined the proposal for an insurance fund for futures customers, and if not, would you be willing to undertake an analysis of the proposal? (DSIO)

Response to questions 3 and 4: I am certainly open to an insurance fund, but recognize that the discussion will require a consideration of costs and benefits. As market participants and other stakeholders join Congress in considering the matter, I look forward to the discussion. In the meantime, I think we have to focus on everything that can be done to best protect the public with current authorities. To that end, the Commission looks forward to reviewing public comments on proposed rules to enhance customer protections.

Technology

5) Focusing on technology, what took so long for the National Futures Association, or the CFTC for that matter, to switch to electronic monitoring of customer segregated accounts?

6) It seems that technology should have been easily available for some time, so why wasn't this step taken sooner?

Response to questions 5 and 6: The Commission recently proposed amending its regulations to require entities holding customer funds to provide read-only direct electronic access to the Commission and to the FCMs' designated self-regulatory organization. Commission staff are consulting with depository institutions with regard to their ability to provide direct electronic access, particularly on a real-time basis. The SROs are continuing to work toward the goal of having all depositories provide the Commission and SROs with direct electronic access to account balances holding customer funds.

The Commission will continue to pursue the use of technology to enhance its oversight of how FCMs hold customer funds and comply with Commission segregation requirements.

Senator Saxby Chambliss

1) As the CFTC prepares to publish an initial list of swaps to be subject to the clearing mandate it appears that Europe will not be prepared to have any such clearing mandate in effect until 2013. What is the timing in Asia for an enforceable mandatory clearing requirement? What impact do you expect if the timing of the mandates is not coordinated?

Response: Regulators across the globe continue to work together towards achieving common goals including the G-20 agreement of September 2009 that: all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the

Senate Agriculture Committee Hearing
Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
Tuesday, July 17, 2012
Questions for the Record
Responses of CFTC Chairman Gary Gensler

latest; OTC derivative contracts should be reported to trade repositories; and non-centrally cleared contracts should be subject to higher capital requirements.

The Dodd-Frank Act fulfilled that agreement by calling for the movement of all standardized swaps into central clearing. The Commission has approved rules providing for the process of approving swaps under the clearing requirement. The Commission reviews the submission of a derivatives clearing organization (DCO) and determines whether the swap, or group, category, type, or class of swaps described in the submission is required to be cleared. The Commission has proposed a mandatory clearing requirement under those rules that would cover four classes of interest rate swaps and two classes of credit default swaps.

The CFTC continues to work closely with the European Union, Asian and Canadian jurisdictions with regard to financial regulatory reform, and in accordance with the requirements of the Dodd-Frank Act that the Commission consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to swap market regulation.

Regulators in Japan adopted legislation in May 2010 which mandates clearing of certain swaps. The Japan Financial Services Agency (JFSA) published a cabinet office ordinance, taking effect in November 2012, to require that certain index-based CDS and certain yen-denominated interest swaps be subject to mandatory clearing. The JFSA may expand its mandatory clearing coverage to include U.S. dollar- and euro-denominated interest rate swaps, as well as yen-denominated interest rate swaps referencing TIBOR.

The Securities and Futures Commission and Hong Kong Monetary Authority jointly released a consultation paper addressing mandatory clearing on October 17, 2011. This consultation plan described a phased implementation approach where clearing requirements will initially cover standardized interest rate swaps and non-deliverable forwards. Hong Kong regulators are working with their legislature to introduce a bill to the legislative council in coming months. Their published timetable anticipates that legislation will be fully implemented by mid-year 2013.

The Monetary Authority of Singapore (MAS) released a consultation paper addressing mandatory clearing on February 13, 2012. Based on a preliminary review, the MAS expects Singapore dollar interest rate swaps, U.S. dollar interest rate swaps, and Asian currency non-deliverable forwards to meet its proposed mandatory clearing criteria. Additional swaps will be considered for mandatory clearing via clearinghouse submission or upon the review of MAS.

According to a June 15, 2012, progress report issued by the Financial Stability Board (FSB), “[j]urisdictions now have much of the information they requested in order to make informed decisions on the appropriate legislation and regulations to achieve the end-2012

Senate Agriculture Committee Hearing
 Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
 Tuesday, July 17, 2012
 Questions for the Record
 Responses of CFTC Chairman Gary Gensler

commitment to centrally clear all standardised OTC derivatives.” The FSB urged all jurisdictions to work toward meeting the G-20 commitment to implement mandatory clearing by the end of 2012.

The Commission is working diligently to meet the G-20 commitment and fulfill the requirements of the Dodd-Frank Act. We continue to work with authorities from around the globe to ensure that our efforts are coordinated.

2) Chairman Gensler, earlier this month the CFTC released its guidance on cross border swaps. It allows for “substituted compliance” – which seems to mean that US regulators will defer to home country regulators for entity-level requirements (like capital, risk management, CCO) where the home jurisdiction has comparable requirements. At the same time, the agency released an exemptive order extending the time for compliance with the entity level rules for 12 months following the registration compliance date. This order will evidently allow the CFTC time to determine which countries have comparable regulation. This new approach seems to ensure in a detailed way that foreign jurisdictions meet our standards for acceptable regulation and supervision. This new approach prompts a number of questions:

- a) Is the “substituted compliance” concept essentially just going to require foreign jurisdictions to adopt US rules?
- b) Will countries that follow principals versus a prescriptive approach to regulation be eligible for substituted compliance? Could substituted compliance be tantamount to fixing what’s not broken?

Response to questions 2(a) and 2(b): Under the proposed guidance, the CFTC would permit substituted compliance with certain Dodd-Frank requirements for non-U.S. swap dealers and major swap participants, allowing such entities to conduct business by complying with their home country regulations, if the CFTC finds that such requirements are comparable to analogous requirements under the Dodd-Frank Act. The Commission would retain discretion in its determination of whether to permit substituted compliance with foreign regulations. The agency would consider the scope and objectives of the relevant foreign regulatory requirements, the comprehensiveness of those requirements, the foreign regulator’s supervisory compliance program, and the foreign regulator’s authority to oversee the non-U.S. swap dealer or major swap participant. The CFTC may determine that the objectives of any program elements are met and thus permit compliance with the relevant foreign regulation, notwithstanding the fact that the foreign requirement may not be identical to that of the CFTC.

Senate Agriculture Committee Hearing
Dodd-Frank Wall Street Reform and Consumer Protection Act: 2 Years Later
Tuesday, July 17, 2012
Questions for the Record
Responses of CFTC Chairman Gary Gensler

c) How much more will it cost to analyze foreign regulatory regimes, and to monitor -- as the proposed Volcker Rule would require -- trading activities outside the US, including where US taxpayers may not be at risk?

Response: The Dodd-Frank Act requires that the CFTC, the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller Currency, and the Federal Deposit Insurance Corporation to write regulations that implement the Volcker Rule. The CFTC and the other Agencies are in the process of evaluating and reviewing each of the comments that were received on the proposed Volcker Rule. The CFTC is aware of the concerns raised by commenters that the Volcker Rule may impose additional costs related to both (i) analyzing foreign regulatory regimes and (ii) monitoring trading activities outside the United States. The CFTC and the other Agencies are discussing these extra-territoriality issues, among others, as they work toward finalizing the Volcker Rule.

d) Do you perceive any unintended consequences -- like a movement of capital markets activity away from the US, leading to a higher cost of funding for US companies? Or new requirements imposed on U.S. banks by foreign countries which could be inconsistent with U.S. rules?

Response: The proposed Volcker Rule asked numerous questions on potential effects, including its impact on capital markets. In particular, the proposal sought public comment on effects on liquidity, efficiency, and price transparency. The CFTC and the other agencies are in the process of evaluating and reviewing the comments that were received on the proposed rule. Some commenters raised the concern that the proposed rule may result in unintended consequences, including the potential migration of capital markets activity away from the United States. The CFTC and the other agencies continue to examine public comments and to consult on the Volcker Rule's potential effects on US capital markets as we work toward a final rule.

**OVERSIGHT OF THE SWAPS AND FUTURES
MARKETS: RECENT EVENTS AND
IMPENDING REGULATORY REFORMS**

HEARING
BEFORE THE
COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES
ONE HUNDRED TWELFTH CONGRESS
SECOND SESSION

JULY 25, 2012

Serial No. 112-34



Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

75-437 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

SUPPLEMENTARY MATERIAL SUBMITTED BY HON. GARY GENSLER, CHAIRMAN,
COMMODITY FUTURES TRADING COMMISSION

During the July 25, 2012 hearing entitled, *Oversight of the Swaps and Futures Markets: Recent Events and Impending Regulatory Reforms*, requests for information were made to Mr. Gensler. The following are his information submissions for the record.

Insert 1

Mr. COSTA. Do you anticipate being able to coordinate resources with clearinghouses? You are talking about the timelines in Japan, the timelines in Hong Kong, and the timelines for implementation in Europe with those other clearinghouses to try to provide a worldwide regulatory framework.

Mr. GENSLER. I think we are coordinating well but we have different politics and different cultures so there will be different timelines. In some countries, they might be significantly later than us but I am encouraged by Europe and Japan and Canada.

Mr. COSTA. For your discussion of those timelines, could you provide the Committee, because you talked about you are almost at the rulemaking now, what you see the timelines out for the next 2 years? Would that be possible?

Mr. GENSLER. I am sorry. Did you say for the next—

Mr. COSTA. Two years.

Mr. GENSLER. Two years? I think we can provide something to you in terms of the rules that are already finalized when there are compliance dates and then second, when we—

Mr. COSTA. Mr. Chairman, I would like that provided to the Committee so that we can all have a better understanding of that.

A core provision of title VII of the Dodd-Frank Act is the requirement that standardized swaps be centrally cleared. The Act includes an exception for non-financial end-users, with the requirement only applying to a transaction where both counterparties are subject to it.

For swaps submitted to the Commission for mandatory clearing, the Commission will review the submission and determine whether the swap, or group, category, type, or class of swaps described in the submission is required to be cleared. The Commission, generally, is to make its determination within 90 days after a complete submission. The Commission recently finalized a mandatory clearing requirement that covers specified classes of interest rate and credit default swaps.

Commission rules regarding the clearing requirement include phased compliance for different categories of market participants. Transactions involving only swap dealers will be subject to earlier compliance than those between swap-dealers and non-swap dealers. Additional time is provided before compliance is required with respect to a transaction that does not have a swap dealer as a counterparty.

U.S. timing regarding the clearing requirement broadly aligns with both Japan and Europe.

The legislature in Japan adopted legislation in May 2010 which mandates clearing of certain swaps. Japanese regulators recently published the requirement that certain index-based CDS and certain yen-denominated interest swaps to be subject to mandatory clearing. In addition, the Japanese Financial Services Agency is considering expanding its mandatory clearing coverage to include U.S. dollar- and euro-denominated interest rate swaps, as well as yen-denominated interest rate swaps referencing TIBOR.

The European Securities and Markets Authority has published its technical standards for clearing, reporting and certain risk mitigation rules for adoption by the European Commission.

The Commission continues to consult closely with fellow regulators in Australia, Hong Kong Singapore, and other jurisdictions.

In June, the Commission—consulting closely with domestic and foreign regulators—proposed guidance interpreting the cross-border application of the swaps market reforms of the Dodd-Frank Act. In a separate release, the Commission proposed phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) regarding certain requirements of Dodd-Frank swaps market reform.

Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion. It would allow time for the CFTC, international regulators and market participants to continue coordinating on regulation of cross-border swaps activity. And it would allow for appropriate implementation of substituted compliance, or allowing market participants to comply with Dodd-Frank through comparable and comprehensive foreign regulatory requirements.

The CFTC has a consistent record of relying on comparable home country regulation where appropriate. We are very much committed to recognition regimes for swaps market reforms as well, where there are comparable and comprehensive requirements.

The CFTC also has had a long history of working with international regulators to coordinate oversight of cross-border entities. We have done so with regard to clearinghouses, futures commission merchants and foreign boards of trade.

Insert 2

Mrs. NOEM. Thank you, Mr. Chairman, and I appreciate this hearing. It is timely given it is the second anniversary of the Dodd-Frank and we need to look at these reforms and the related rules and see how they impact people on the ground. For example, in South Dakota, where I am from, some businesses and producers who are actively investing in the commodity market are still dealing with the failure of MF Global, so I just have a couple questions for you.

Does the CFTC have the power to force a firm into bankruptcy?

Mr. GENSLER. We might need to get back to you, but I am not aware of that. Even in this Peregrine situation, we went into court to ask for a receiver to be appointed to freeze the assets, which we do in Ponzi schemes as well. So I think that is the route. I believe the answer is no but we seek a court to appoint a receiver.

Mrs. NOEM. Okay. That is the route that is generally followed? Well, if there is more information on that that you can give me later, I would appreciate that. That would be great.

The attached CFTC staff memorandum discusses the applicable laws that affect the insolvency of a futures commission merchant that is also a broker dealer.

ATTACHMENT

Memorandum

From: Robert B. Wasserman, Chief Counsel, Division of Clearing and Risk
 Re: SIPA Proceedings for insolvent FCMs
 Date: April 1, 2012

Introduction

The following is an analysis of the circumstances where the insolvency of a Futures Commission Merchant that is also a Broker Dealer would proceed under the Securities Investors Protection Act, 15 U.S.C. § 78aaa, *et. seq.* (SIPA) rather than as a commodity broker bankruptcy under Subchapter IV of Chapter 7 of the Bankruptcy Code, 11 U.S.C. § 761, *et. seq.* (Subchapter IV).

As discussed further below, jurisdiction under SIPA is based on the existence of at least one securities customer whose claims may be satisfied by SIPC, rather than on the predominance of securities customers *versus* commodity customers. However, as also discussed further below, the interests of commodity customers are not ignored under SIPA.

Discussion

Futures Commission Merchants ("FCMs") are the financial intermediaries for futures market transactions.¹ A bankrupt FCM which has a "customer," as that term is defined in the Bankruptcy Code, is known as a "commodity broker."² A commodity broker bankruptcy must proceed as a liquidation under Chapter 7 of the Bankruptcy Code, rather than a reorganization under Chapter 11, and the trustee has duties specified in Subchapter IV of Chapter 7.³ Chief among those duties is the duty to endeavor to transfer the positions of customers of the FCM to a solvent FCM.⁴ The financial intermediaries for securities are known as broker dealers ("BDs"), and the insolvency of a BD proceeds under SIPA. For the reasons that follow, the insolvency of an entity that is both a commodity broker and a BD (a "BD/FCM") will, so long as there is at least one securities customer, proceed under SIPA.

Section 5(a)(1) of SIPA⁵ provides that "[i]f the [SEC] is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or is approaching financial difficulty, it shall immediately notify SIPC."

Section 5(a)(3)(A)(A) provides that SIPC may file an application for a protective decree with respect to a member with *any* (securities) customers if it determines

¹ See generally, Commodity Exchange Act ("CEA") §§ 1a(28), 4d, 7 U.S.C. §§ 1a(28), 6d.

² See Bankruptcy Code (hereinafter "Code") § 101(6), 11 U.S.C. § 101(6).

³ See Code § 109(d), §§ 761 *et. seq.*

⁴ See 17 CFR § 190.02(e)(1).

⁵ Section 5 of SIPA is codified at 15 U.S.C. § 78eee.

that the member “has failed or is in danger of failing to meet its obligations to customers” and one of the conditions specified in § 5(b)(1) of SIPA exists.⁶ Those latter conditions include (a) that the debtor is insolvent, or (b) that a proceeding is pending before any court or agency of the United States in which a receiver, trustee, or liquidator for such debtor has been appointed, or (c) that the debtor is not in compliance with the rules of the SEC or an SRO with respect to financial responsibility or hypothecation of customer securities, or (d) that the debtor is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

There is no means for the CFTC to effect the placement of a BD/FCM into a Chapter 7, Subchapter IV proceeding that avoids SIPA. If the BD/FCM were to file for relief under Chapter 7 of the Bankruptcy Code, the U.S. Trustee would appoint a trustee from among the panel of persons established by the U.S. Trustee for that jurisdiction.⁷ If the CFTC were to take action to appoint a receiver for an FCM with the intention that the receiver file for bankruptcy, that would, by assumption, involve the appointment of a receiver. In either case, the condition in (h) above would be established. Moreover, pursuant to § 5(a)(3)(B) of SIPA, “[n]o member of SIPC that has a customer may enter into an insolvency, receivership, or bankruptcy proceeding, under Federal or State law, without the specific consent of SIPC, except as provided in title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.”

Accordingly, so long as there is at least one securities customer, the CFTC has no way to prevent SIPC from initiating a SIPA proceeding, and SIPA prevents the initiation of a Chapter 7, Subchapter IV proceeding without SIPC’s specific consent.

Additionally, once SIPC initiates a SIPA proceeding, the district court is, pursuant to Section 5(b)(2)(B)(i) of SIPA, obligated to “stay any pending bankruptcy, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the debtor or its property and any other suit against any receiver, conservator, or trustee of the debtor or its property, and shall continue such stay upon appointment of a [SIPC] trustee.” Thus, any Subchapter IV proceeding must be stayed by the district court in a SIPA proceeding.

Thus, the only effect that FCM or CFTC action to cause the initiation of a Subchapter IV proceeding with respect to a BD/FCM can have is to confine and complicate the insolvency of the BD/FCM. Moreover, the succession of trustees and confusion with respect to jurisdiction is likely to delay the circumstances in which the commodity customer positions and any available associated collateral are transferred from the insolvent FCM to other FCMs.

This does not mean that the interests of commodity customers are ignored in a SIPA proceeding. Specifically, SIPA § 7(b)⁸ provides that

“To the extent consistent with the provisions of this chapter or as otherwise ordered by the court, a trustee shall be subject to the same duties as a trustee in a case under chapter 7 of Title 11, including, if the debtor is a commodity broker, as defined under section 101 of such title, the duties specified in subchapter IV of such chapter 7, except that a trustee may, but shall have no duty to, reduce to money any securities constituting customer property or in the general estate of the debtor.”

Thus, commodity customers in a SIPA proceeding do not, pursuant to SIPA, suffer any disadvantage relative to commodity customers in a Subchapter IV proceeding.

Insert 3

Mr. STUTZMAN. September 1, 2011, MF Global announces in a public filing that it would comply with FINRA’s determination and increase its capital. Would such a filing trigger any red flags at CFTC?

Mr. GENSLER. As I am not participating, I don’t know what the Commissioners or the agency looked at about that September 1st filing. But just as a general matter, our examination staff will work with the self-regulatory organizations like FINRA and Chicago Mercantile Exchange and NFA on any filings about capital and try to understand what those filings are.

Mr. STUTZMAN. So did that happen? Did your agency work with FINRA at all?

⁶SIPA § 5(a)(3)(A) provides that no application shall be filed by SIPC with respect to a member, the only customers of which are persons whose claims could not be satisfied by SIPC advances pursuant to Section 9 of SIPA. MFG did not fall within this exception.

⁷Code § 701a(x1).

⁸15 U.S.C. 78ff-1(b).

Mr. GENSLER. Again, I don't know because I haven't gone back and done the forensics. I haven't been involved since this whatever, November 2nd or 3rd period of time.

Mr. STUTZMAN. Is that something you could find out and notify—

Mr. GENSLER. Our General Counsel, Dan Berkovitz, will follow up with you.

At the end of August 2011, SEC staff contacted CFTC staff regarding MF Global's repo to maturity transactions.

On September 19, 2011, CFTC staff held a teleconference with FINRA staff to obtain further information regarding the repo to maturity transactions.

On October 25, 2011, CFTC staff spoke with FINRA staff regarding MF Global. During this call, FINRA discussed certain additional steps it had taken to monitor MF Global.

On October 27, 2011, staff in the CFTC New York Regional office was contacted by SEC staff. CFTC staff ultimately joined the SEC staff in a meeting at MF Global that was the initiation of an SEC examination of the firm.

On October 28, 2011, CFTC staff spoke with FINRA staff regarding the status of MF Global.

On October 30, 2011, CFTC and SEC staff participated in a conference call with MF Global regarding MF Global's financial status and the production of documents related to that status.

Insert 4

Mr. CONAWAY . . . Chairman, one real quick follow-up. Section 722(d) is the section you cite that gives you the authority to do the guidance on the extraterritorial or cross-border; 722(c), we think gives the SEC similar authority. What is y'all's understanding or can you help us understand your interpretation of those two different sections?

Mr. GENSLER. Section 722(c) would be in the swaps section of the statute. It may well that you want to follow up with—

Mr. CONAWAY. Okay, if you wouldn't mind getting back with us on that because—

Mr. GENSLER. Because I understood that it is all in the first part of that Title VII is swaps, which is the CFTC, and then of course the other section later in the chapter is there but 722(c), Dan? Maybe we will have to—

Mr. CONAWAY. All right. We will follow up with you on that if you wouldn't mind.

Section 722(d) of the Dodd-Frank Act relates to the CFTC's extraterritorial jurisdiction over swaps. Subtitle B of Title VI, sections 761 through 744, applies to securities-based swaps under the jurisdiction of the Securities and Exchange Commission.

SUBMITTED LETTER TO HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION FROM HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS AND RESPONSE

August 21, 2012

Hon. GARY GENSLER,
Chairman,
 Commodity Futures Trading Commission,
 Washington, D.C.

Dear Chairman Gensler:

Thank you for your recent testimony before the House Committee on Agriculture hearing entitled, *Oversight of the Swaps and Futures Markets: Recent Events and Impending Regulatory Reforms*. This letter serves as a follow-up to my questions inquiring about the coordination between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) with respect to the extraterritorial application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). As you will recall, I asked you during the hearing to clarify why the statutory language found in Section 722(d) of Title VII of the Dodd-Frank Act serves as the legal rationale for the CFTC's inability to issue a joint rule with the SEC on cross-border jurisdiction.

As a follow-up, could you please explain why Section 722(d), which governs swaps under the CFTC's jurisdiction, and Section 772(c), which governs security-based swaps under the SEC's jurisdiction, prevents the two Commissions from coordinating on a single joint rulemaking?

As you know, Section 722(d) of Dodd-Frank provides that Title VII “shall not apply to activities outside the United States” unless those activities “have a direct and significant connection with activities in, or effect on, commerce of the United States” or “contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by [Title VII].” Similarly, Section 772(c) of Dodd-Frank provides that “[n]o provision of [Title VII] shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of [SEC rules].”

My plain-language reading of Sections 722(d) and 772(c) appears to be a limitation on the extraterritorial reach of both agencies, not a mandate that prohibits the CFTC from engaging with the SEC on a joint rulemaking. In fact, Sections 712(a)(1) and 712(a)(2) of Dodd-Frank both require that the CFTC and SEC “consult and coordinate . . . for the purposes of assuring regulatory consistency and comparability, to the extent possible.”

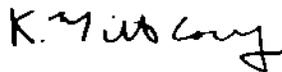
Section 712(a)(7)(A) further reinforces this point by stating that the CFTC and SEC “shall treat functionally or economically similar products or entities . . . in a similar manner.” As you well understand, no joint rulemaking between the CFTC and SEC on the extraterritorial regulation of swaps and security-based swaps would require that both types of contracts be treated identically by the two agencies. Rationales to provide different regulatory treatment for very specific types of contracts would certainly exist within a jointly-written rule. Indeed, Dodd-Frank Section 712(a)(7)(B) expressly provides the CFTC and SEC with the flexibility that economically similar products need not be treated in an identical manner. Read together, all of the Dodd-Frank sections referenced above seem to logically point to a thorough joint rulemaking on cross-border regulation from the CFTC and SEC.

However, I am concerned that the CFTC’s proposed cross-border guidance released on June 29, 2012, is the first action which will ultimately result in swaps and security-based swaps being governed by two very different regulatory regimes. From a regulatory compliance standpoint, the most-restrictive guidance or rule-making will likely become the *de facto* standard for the entire swaps and security-based swaps marketplace. Nevertheless, we must avoid the illogical creation of a disparate regulatory environment that would result in the same market participant being a “U.S. person” for trading in swaps while simultaneously considering them a “non-U.S. person” for trading in security-based swaps.

Finally, Section 752(a) of the Dodd-Frank Act requires the CFTC and SEC to seek harmonization on an international level by consulting and coordinating “with foreign regulatory authorities on the establishment of consistent international standards” for swaps regulation. Absent consistent regulatory standards proposed by our own domestic regulators, effective coordination between U.S. and foreign regulators would seem virtually impossible. How does the CFTC plan to coordinate with international regulators if swaps and security-based swaps are governed by two different extraterritorial regulatory regimes?

Thank you again for answering the questions above related to the creation of a consistent regulatory regime for the swaps and security-based swaps marketplace. I look forward to receiving your written response by Friday, September 7, 2012, so it can be included in the official Committee hearing record.

Sincerely,



Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management.

October 10, 2012

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway:

Thank you for your letter of August 21, 2012, following up on our discussion during the Committee on Agriculture’s hearing of July 25, 2012.

The Commodity Exchange Act (CEA)—as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act—directs the Commodity Futures Trading Commission (CFTC) to implement swaps market reforms, to coordinate closely with other domestic regulatory agencies, and to coordinate as well with regulators in foreign jurisdictions. In addition, in particular instances, Congress has directed the CFTC to conduct rulemakings jointly with the Securities and Exchange Commission (SEC). The two Commissions worked well and closely together to complete this year final joint rules that further define important terms.

In addition to cooperating on joint rules, the CFTC and the SEC are coordinating closely in writing other rules to implement the derivatives provisions of the Dodd-Frank Act. We coordinate and consult on each rulemaking, including sharing many of our memos, term sheets and draft work product. This close working relationship has benefited the rulemaking process, and will continue throughout completion of rulemaking and implementation. Staffs of the SEC and CFTC have jointly held a number of roundtable discussions to obtain the public's views.

This process of consultation and coordination has been followed with regard to considerations of the cross-border application of Dodd-Frank. On August 1, 2011, staffs of the two Commissions hosted a roundtable discussion on international issues relating to the implementation of title VII of the Dodd-Frank Act. This meeting as well as public comments and other meetings have facilitated the agencies' understanding of related issues as well as helped us to share a common understanding with regard to the important matters to be addressed by both Commissions in our joint and separate rulemakings.

Section 722(d) of the Dodd-Frank Act states that swaps market reforms under the CEA shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States." The Commission has received requests from market participants seeking the agency's interpretation of swap market reforms in light of that provision.

In June, the Commission—consulting closely with domestic and foreign regulators—proposed guidance interpreting the cross-border application of the Dodd-Frank Act. In a separate release, the Commission proposed phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) regarding certain requirements of Dodd-Frank swaps market reform.

Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion. It would allow time for the CFTC, international regulators and market participants to continue coordinating on regulation of cross-border swaps activity. And it would allow for appropriate implementation of substituted compliance, or allowing market participants to comply with Dodd-Frank through comparable and comprehensive foreign regulatory requirements.

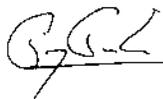
The CFTC has a consistent record of relying on comparable home country regulation where appropriate. We are very much committed to recognition regimes for swaps market reforms as well, where there are comparable and comprehensive requirements.

The CFTC also has had a long history of working with international regulators to coordinate oversight of cross-border entities. We have done so with regard to clearinghouses, futures commission merchants and foreign boards of trade. The Commission has sought public comment regarding these releases and the Commission staff is closely reviewing that input in preparation for final action.

As the process of swaps market reform implementation proceeds, the Commission will continue to work closely with the SEC and other domestic regulators. The Commission is also working closely with regulators in foreign jurisdictions—often sharing memos, term sheets and draft work product as we do with other domestic agencies. These efforts are designed to assure regulatory consistency and comparability to the extent possible, taking into consideration differences in markets and in the applicable statutory requirements.

Thank you for your letter and for your support of the work of the CFTC. If I can be of further assistance, please do not hesitate to let me know.

Sincerely,



HON. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission.

SUBMITTED QUESTIONS

Response from Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission

Questions Submitted by Hon. Frank D. Lucas, a Representative in Congress from Oklahoma

Question 1. Chairman Gensler, I received the following questions on August 2, 2012, in a letter from the following members of the Florida Congressional delegation: Representatives Stearns, Posey, Mica, Nugent, Ross, West, Rivera, Buchanan, Ros-Lehtinen, Young, and Miller:

How has the [LIBOR] manipulation affected the housing market in Florida?

Question 2. With such a large population of older Americans in Florida, have our constituents' retirement savings been disproportionately affected compared to the rest of the country?

Question 3. How has the LIBOR manipulation affected private student loan interest rates, which according to the Consumer Financial Protection Bureau, has surpassed credit card debt as the biggest source of unsecured debt for U.S. consumers?

Answer 1-3. The Commission does not have data on the on the Florida housing market or on private student loans, nor did the Commission's order find the effect of Barclays actions on LIBOR. The Commission's order stated that Barclays repeatedly attempted to manipulate and made false, misleading or knowingly inaccurate submissions concerning LIBOR.

Question 4. What work is the CFTC doing to aid the Department of Justice in civilly and criminally charging those involved?

Answer. The Commission's Division of Enforcement referred the Barclays matter to the Department of Justice. That referral culminated in an agreement with the Fraud Section of the U.S. Justice Department's Criminal Division, in which Barclays agreed to pay a \$160 million penalty and to continue to cooperate with the Department.

Question 5. How does the CFTC plan to help state governments assess the impact the LIBOR fraud has had on them as individual states?

Answer. In appropriate circumstances and with appropriate confidentiality agreements in place, we can and often do share information with state law enforcement authorities. In fact, the Commission's Office of Cooperative Enforcement, a unit of the Division of Enforcement, has the goal of ensuring that enforcement of the commodity futures laws is addressed through civil, criminal, or administrative actions by state and Federal agencies or branches of government whenever possible.

Question Submitted by Hon. K. Michael Conaway, a Representative in Congress from Texas

Question. Chairman Gensler, do you have any reason to believe the CFTC would have uncovered this fraud sooner had it been tasked with the audit of Peregrine instead of the NFA? If the CFTC had the sole authority to audit market participants, what would you and your staff have done differently?

Answer. The regulatory system did not adequately protect Peregrine's customers. More needs to be done to protect customers. The Commission is proceeding to consider staff recommended proposed rules that incorporate three key reforms recently adopted by the NFA and would require:

- FCMs to hold sufficient funds in Part 30 secured accounts (funds held for U.S. foreign futures and options customers trading on foreign contract markets) to meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. FCMs would no longer be allowed to use the alternative method, which had allowed them to hold a lower amount of funds representing the margin on their foreign futures;
- FCMs to maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more would necessitate pre-approval in writing by senior management and must be reported to the designated SRO and the CFTC; and
- FCMs to make additional reports available to the SRO and the CFTC, including daily computations of segregated and Part 30 secured amounts.

Additional reforms in the staff recommendations include requiring that SROs and the CFTC have direct electronic access to FCMs' bank and custodial accounts for customer funds, that acknowledgement letters and confirmation letters come directly to regulators from banks and custodians, enhanced risk disclosures to cus-

tomers, setting standards for the SROs' examinations and the annual certified financial statement audits, including raising minimum standards for independent public accountants who audit FCMs and implementing a more effective early warning system for the Commission and the SROs that alert them to material events.

If the Commission approves the staff recommendations, further public comment will be of great value to the agency in devising final rules that best ensure the protection of customer funds.

Regarding the Commission's oversight of SROs and intermediaries, though we're making progress through our reorganization at the CFTC and new rules, the recent events at Peregrine highlight the necessity of looking at the decades-old system of SROs and the Commission's role in overseeing SROs.

I have directed the CFTC's staff to do a full review of how the agency conducts oversight of the SROs, as well as limited scope reviews of FCMs, to determine what improvements can and should be made. As part of this review, we have reached out to the Public Company Accounting Oversight Board (PCAOB), which oversees the audits of public companies. The Dodd-Frank Act gave the PCAOB oversight authority over the audits of brokers and dealers who are registered with the Securities Exchange Commission. The PCAOB has agreed to give us the benefit of its insights and expertise.

Questions Submitted by Hon. Scott R. Tipton, a Representative in Congress from Colorado

Question 1. The FCS is a government sponsored enterprise (GSE) that is made up of 4 Federal Farm Credit Banks and approximately 80 lending associations. All System entities are jointly and severally liable for the actions of each other component of the System—in other words, the actions of one FCS lender ultimately will impact the entire System. Congress designed it that way. With this system of interlocking liability in mind, the FCS could be considered a \$231 Billion financial services institution. Did the Chairman consider this fact when he issued the "Clearing Exemption for Certain Swaps Entered into by Cooperatives"?

Question 2. The central idea advanced by the CFTC in the recently proposed "Clearing Exemption for Certain Swaps Entered into by Cooperatives" is that the FCS banks lend to the FCS associations, which lend to farmers, and farmers own the FCS associations, which own the FCS banks—principally that the Farm Credit System is a cooperative. CFTC then proposes that "cooperatives meeting certain conditions are the class of persons that should be exempted from the clearing requirement for certain types of swaps, cooperatives act on behalf of their members in certain financial matters. The proposed rule provides for passing through the end user exemption available to such cooperative's members." I find your logic lacking here. Why does who owns an entity make any difference in the regulation of the derivatives market?

Question 3. You observe in the proposed rule: "cooperatives have a member ownership structure in which the cooperatives exist to serve their member owners and not act for their own profit. In a real sense the cooperative is not separable from its member owners." What is unique about the ownership structure of cooperatives that would prevent a large financial institution like the Farm Credit System from making stupid, imprudent, wrong, or costly mistakes? Haven't you have been charged to regulate the derivatives market to protect the financial system from stupid, imprudent, wrong and costly mistakes? Doesn't exempting a financial cooperative with assets of more than \$230 billion from certain derivatives activities expose the entire financial system to unintelligent, imprudent, wrong or costly mistakes?

Answer 1-3. The comment period for the CFTC's proposed rule on a "Clearing Exemption for Certain Swaps Entered into by Cooperatives" ended on August 16, 2012. In response to this proposal, the CFTC received comment letters from market participants and interested members of the public. The Commission is reviewing these letters and evaluating the various issues raised by commenters. The CFTC will consider the issues surrounding the proposed exemption for certain cooperative swaps and cooperative structure.

Question Submitted by Hon. Mike McIntyre, a Representative in Congress from North Carolina

Question. Chairman Gensler, in the proposed rule on Product Definitions you asked a number of questions of the electric industry, and I understand that the electric utilities responded and answered the staff's questions. As you know, the Products Definitions final rule subjected the capacity and transmission contract language to further comment. It is my understanding that these transactions—capacity contracts, transmission contracts and tolling agreements—are forwards or forwards with embedded options, and not swaps. I believe it was not the intent of Congress

to consider such transactions swaps under the Dodd-Frank Act. Would you please clarify the CFTC's need for further comment on capacity and transmission contracts (used to ensure delivery of electric power to utilities and their consumers) in the Products Definition final rule?

Answer. Under the Commission's final Product Definition rule, depending on the relevant facts and circumstances involved, capacity contracts, transmission contracts, and tolling agreements may qualify as forwards. The Commission issued interpretive guidance in this regard for market participants.

The Commission also believed that it would benefit from further input about that guidance and requested public comment by Oct. 12, 2012. Once this comment period has closed, the Commission will analyze the issues raised by the commenters.

**EXAMINING THE FUTURES MARKETS:
RESPONDING TO THE FAILURES
OF MF GLOBAL AND PEREGRINE
FINANCIAL GROUP**

HEARING
BEFORE THE
**COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY**
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS
SECOND SESSION

—————
AUGUST 1, 2012
—————

Printed for the use of the
Committee on Agriculture, Nutrition and Forestry



Available via the World Wide Web: <http://www.fdsys.gov/>

U.S. GOVERNMENT PRINTING OFFICE

78-277 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

QUESTIONS AND ANSWERS

AUGUST 1, 2012

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Responses of Chairman Gary Gensler

Ranking Member Pat Roberts

1) It is my understanding that your staff feels they have gone as far as they can under the current bankruptcy regime by increasing collateral protection with the LSOC model the Commission adopted earlier this year. Is this correct?

Response: Section 766(h) of the Bankruptcy Code requires that customer property be distributed on a pro rata basis, which limits the Commission's ability to provide for the individual segregation of customer collateral. The Commission cannot adopt regulations that would segregate collateral on an individual basis. The Commission adopted LSOC earlier this year, which enhanced the available protections for customer collateral for swaps.

The Commission has directed staff to, among other things, consider the viability of adopting LSOC for futures customer funds. To that end, staff held a two-day customer protection roundtable in late February. At that roundtable, market participants discussed the benefits and disadvantages of adopting LSOC for futures. Participants largely acknowledged that the advantage would be enhanced protection for futures customers, while the disadvantage would be the risk and operating costs of adopting LSOC for futures, which could be greater in futures than in swaps. Given the issues identified at the roundtable, some market participants requested that the Commission focus on implementing LSOC for swaps before further considering LSOC for futures.

The Commission recently issued proposed rules to further enhance customer protections based on staff recommendations. The Commission looks forward to reviewing public comments on that rulemaking.

2) We continue to hear from market participants, including NGFA today, that they want to be able to utilize tri-party custody arrangements for the cleared swaps and futures, much like Europe. Would this require legislative action, including a change to the Bankruptcy Code?

Response: As I understand it, because of the pro rata distribution requirements, a tri-party custody arrangement that would be expected to result in individualized protection for customers would not be permitted.

3) If so, why haven't you asked Congress for this? All I see you doing is approving initiatives the NFA has put in front of you. You have told this Committee you are in charge of the policy response to MF Global, despite being recused from the enforcement matters. If you are in charge, where is the response? If we need to do something why aren't you asking us?

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Responses of Chairman Gary Gensler

Response: The Commission recently approved a proposed rulemaking with enhancements to protections for futures customers and their funds. This proposal is about ensuring customers have confidence that the funds they post as margin or collateral are fully segregated and protected.

It is the direct result of significant input from the public and market participants that the CFTC gathered throughout 2012, working with the Futures Industry Association, the NFA and the self-regulatory organizations.

The proposal, which the CFTC looks forward to finalizing in 2013, would strengthen the controls around customer funds at futures commission merchants (FCMs). It also would set new regulatory accounting requirements that would provide stronger protections for customer money held by FCMs and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to FCMs' bank and custodial accounts for customer funds.

In addition, both the Commission and the relevant self-regulatory organizations (SROs; the NFA and the CME) have taken steps to improve the protections given to futures customer funds. These measures include improvements to the internal controls and transparency associated with customer funds held by futures commission merchants (FCMs). Commission staff hosted a public Roundtable on February 29 and March 1, 2012 to obtain input on customer protection issues from a broad cross-section of market participants, FCMs, clearing organizations and regulators.

The Commission has been working closely with industry SROs, such as NFA, to implement improved protections for customer funds held with FCMs. NFA's Board of Directors appointed a Special Committee on the Protection of Customer Funds (Special Committee) to identify and recommend to the NFA Board rule amendments to enhance customer protection. The Special Committee's recommended amendments to NFA rules were approved both by NFA's Board and by the Commission.

Specifically, NFA amended its rules regarding segregated funds to establish additional requirements for FCMs to enhance the safety and control of futures customer funds. The amended rules impose additional financial reporting requirements on FCMs regarding the holding and investment of futures customer funds. For example, NFA rules now require FCMs to have written policies and procedures regarding the maintenance of the FCM's residual interest in its customer segregated and Part 30 secured funds accounts. The FCM's policies and procedures must target an amount that the FCM seeks to maintain as its residual interest in these accounts and be designed to reasonably ensure that the FCM remains in compliance with segregation and secured amount requirements at all times.

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Responses of Chairman Gary Gensler

Additionally, any FCM withdrawals in excess of 25 percent of the excess segregated or Part 30 secured funds that are not for the benefit of customers must be pre-approved in writing by the FCM's senior management. Further, under NFA's amended rules, FCMs must file notice with NFA of any withdrawal of 25 percent or more of the excess segregated or Part 30 secured amount funds that are not for the benefit of customers.

Senator Kirsten Gillibrand

1) I know you have used the CFTC's authority to take a number of steps to help improve oversight over the futures markets and customer funds in particular in the wake of MF Global and Peregrine's issues. In addition, to you anticipate making recommendations to Congress about more substantial steps that should be taken to address these issues and restore confidence in the futures market?

Response: The Commission recently approved a proposed rulemaking with enhancements to protections for futures customers and their funds.

This proposal is about ensuring customers have confidence that the funds they post as margin or collateral are fully segregated and protected.

It is the direct result of significant input from the public and market participants that the CFTC gathered throughout 2012, working with the Futures Industry Association, the NFA and the self-regulatory organizations.

The proposal, which the CFTC looks forward to finalizing in 2013, would strengthen the controls around customer funds at futures commission merchants (FCMs). It also would set new regulatory accounting requirements that would provide stronger protections for customer money held by FCMs and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to FCMs' bank and custodial accounts for customer funds.

In addition, both the Commission and the relevant self-regulatory organizations (SROs; the NFA and the CME) have taken steps to improve the protections given to futures customer funds. These measures include improvements to the internal controls and transparency associated with customer funds held by futures commission merchants (FCMs). Commission staff hosted a public Roundtable on February 29 and March 1, 2012 to obtain input on customer protection issues from a broad cross-section of market participants, FCMs, clearing organizations and regulators.

The Commission has been working closely with industry SROs, such as NFA, to implement improved protections for customer funds held with FCMs. NFA's Board of Directors

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Responses of Chairman Gary Gensler

appointed a Special Committee on the Protection of Customer Funds (Special Committee) to identify and recommend to the NFA Board rule amendments to enhance customer protection. The Special Committee's recommended amendments to NFA rules were approved both by NFA's Board and by the Commission.

Specifically, NFA amended its rules regarding segregated funds to establish additional requirements on FCMs to enhance the safety and control of futures customer funds. The amended rules impose additional financial reporting requirements on FCMs regarding the holding and investment of futures customer funds. For example, NFA rules now require FCMs to have written policies and procedures regarding the maintenance of the FCM's residual interest in its customer segregated and Part 30 secured funds accounts. The FCM's policies and procedures must target an amount that the FCM seeks to maintain as its residual interest in these accounts and be designed to reasonably ensure that the FCM remains in compliance with segregation and secured amount requirements at all times. Additionally, any FCM withdrawals that are in excess of 25 percent of the excess segregated or Part 30 secured funds that are not for the benefit of customers must be pre-approved in writing by the FCM's senior management. Further, under NFA's amended rules, FCMs must file notice with NFA of any withdrawal of 25 percent or more of the excess segregated or Part 30 secured amount funds that are not for the benefit of customers.

2) In light of the events and MF Global and Peregrine – in particular, what appears to be nearly two years of outright fraud at Peregrine – do you believe the CFTC has adequate resources for oversight to police the futures markets?

Response: Confidence in the futures and swaps markets is dependent upon a well-funded regulator and the CFTC is a good investment of taxpayer dollars. Its hardworking staff is just 10 percent more than what we had at our peak in the 1990s though the futures market has grown fivefold. The CFTC also is now responsible for the swaps market – eight times bigger than the futures market.

The Commission's limited resources have historically not allowed for direct oversight of FCMs. There are 46 staff members, including 35 audit staff, on the CFTC's examinations team who oversee four SROs, which in turn have responsibilities for more than 4,341 registered persons. In addition, agency responsibilities are expanding to include reviews of many new market participants. For instance, there are currently 115 FCMs, and staff estimates a similar number of swap dealers will ultimately register. More frequent and in-depth risk-based, control-oriented examinations are necessary to assure the public that firms have adequate capital, as well as systems and procedures in place to protect customer money. Greater coverage by regulators – like having more cops on a beat – will improve the integrity and heighten the deterrent effect of the review process.

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Responses of Chairman Gary Gensler

The President's FY2013 budget, following a similar request in 2012, asked for \$308 million, investing in our technology and human resources, to better protect the public.

The Dodd-Frank Act significantly expands the Commission's responsibilities. Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Senate Committee on Agriculture, Nutrition & Forestry
Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine
Financial Group
Questions For The Record
August 1, 2012
Commissioner Jill Sommers

Ranking Member Pat Roberts

1) Firms will have to register as swap dealers in early October. Currently pending are a proposed exemptive order and proposed guidance on the cross-border application of the CFTC's rules, with comments due by August 13th and 27th, respectively. Even with the exemptive relief, firms are being given little certainty and time with which to make major decision, such as which entity to register and to whom supervisory responsibilities should be assigned. Don't you find this problematic?

Answer: Commission staff recently issued a Frequently Asked Questions document clarifying that, although the swap dealer registration regulations go into effect on October 12, under the final swap dealer definitional rule potential swap dealers will have until two months after the end of the month in which they surpass an \$8 billion level of swap dealing to register. This means that the largest swap dealers will not have to register until December 31, and smaller swap dealers may have more time. Even with a December 31 deadline, however, I believe firms will not have sufficient time in which to make decisions regarding which entities to register or how they may have to reorganize their businesses to transfer their swap dealing activity to particular subsidiaries, affiliates, or departments for purposes of registration. I also believe it is problematic for firms to make decisions regarding whether to register as swap dealers before we have finalized critical rules such as capital and margin. The Commission may not complete work on those rules until early 2013, yet we have only extended the registration requirement until December 31, 2012.

WALL STREET REFORM: OVERSIGHT OF FINANCIAL STABILITY AND CONSUMER AND INVESTOR PROTECTIONS

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE AGENCIES' OVERALL IMPLEMENTATION OF THE
DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION
ACT

—————
FEBRUARY 14, 2013
—————

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.fdsys.gov/>

—————
U.S. GOVERNMENT PRINTING OFFICE

80-387 PDF

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

change Act were effective upon enactment, the Commission will need to amend certain rules to reflect these statutory changes. The issue of how a company would determine whether a shareholder qualifies as an accredited investor for purposes of determining the number of holders of record is one that the Commission's staff is aware of and is carefully considering as it prepares recommendations for the Commission.

Q.4. Under Title V—Private Company Flexibility and Growth, Section 502 Employees are family members (including heirs of the employee and trusts established by the employee) included in the definition of persons for purposes of the following: “securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933”?

A.4. In addition to raising the total assets and shareholder thresholds that require registration of a class of security by companies other than banks and bank holding companies, Title V of the JOBS Act excludes shares held by those who received them pursuant to employee compensation plans from inclusion in the number of holders of record. Title V also requires the Commission to adopt a safe harbor for the determination of whether such a holder received the securities pursuant to an employee compensation plan that was exempt from the registration requirements of Securities Act Section 5. The issue of transfers among family members as it applies to the exclusion of employee compensation plan securities under Section 12(g) is one that the Commission's staff is aware of and is carefully considering as it prepares its recommendations for the Commission.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO
FROM GARY GENSLER**

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not “hedging”? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. The Dodd-Frank Act requires that the CFTC, the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller Currency, and the Federal Deposit Insurance Corporation write regulations that implement the Volcker Rule. The CFTC's related Proposed Rule was published on February 14, 2012, along with request for public comment. The Proposed Rule describes seven criteria that a banking entity must meet in order to rely on the hedging exemption. Included is a condition that the transaction in question hedge or otherwise mitigate one or more specific risks, that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge, that the hedging transaction not give rise to significant exposures that are not themselves hedged in a contemporaneous transaction, and other related conditions. The CFTC and the other agencies are in the process of evaluating and reviewing each of the comments that were received

on the proposed Volcker Rule and will address those comments in a Final Rule.

Q.2. Last year the CFTC issued proposed interpretive guidance on cross-border application of the swaps provisions of Dodd-Frank, the so-called extraterritoriality guidance. This guidance received widespread criticism from foreign regulators across the globe for, among other things, not conforming to a G20 agreement, being too expansive in scope and confusing in application. Recently, the CFTC approved an exemptive order delaying the effective date for some of the provisions and issued further cross-border guidance in an attempt to clarify the scope and definition of "U.S. person." However, at least one foreign regulator (The Financial Services Agency of the Government of Japan) sent you a letter stating that the further guidance made the definition even less clear. What steps is the CFTC taking to address those concerns?

A.2. The Commission is reviewing, summarizing, and considering all comments received as it works toward finalizing the cross-border guidance. We are also working bilaterally with domestic and foreign regulators, including the Japanese Financial Services Authority (JFSA), to answer any questions and discuss any issues they have regarding the CFTC's proposals.

OVERSIGHT OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS
FIRST SESSION

—————
FEBRUARY 27, 2013
—————

Printed for the use of the
Committee on Agriculture, Nutrition and Forestry



Available via the World Wide Web: <http://www.fdsys.gov/>

—————
U.S. GOVERNMENT PRINTING OFFICE

87-564 PDF

WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

QUESTIONS AND ANSWERS
FEBRUARY 27, 2013

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
Questions for the record
Chairman Gensler
February 27, 2013

Chairwoman Debbie Stabenow

1. The Board of the National Futures Association recently accepted recommendations provided by the Berkeley Research Group, LLC (BRG). NFA asked BRG to examine, in part, NFA's oversight of Peregrine Financial Group, Inc. before Peregrine's failure. The report discussed the NFA's relationship with the CFTC, recommended increased coordination between the NFA and the CFTC, and discussed NFA's oversight of market participants. The report highlighted what the NFA does well, but also made recommendations on how to improve NFA's audits.
 1. Does the CFTC have a written policy that dictates how and when information should be shared between the NFA and the CFTC, either at the staff level or otherwise? If not, why hasn't this been done? If so, please provide that policy to the Committee.
 2. What is the CFTC's role in setting or approving designated self-regulatory organizations' (DSROs') auditing standards? If the agency has the authority to dictate auditing standards for DSROs, when did the agency last use this authority?
 3. Has the agency ever formally examined the auditing standards of the NFA? If so, when is the last time this took place?
 4. What is the CFTC's relationship, formal or informal, with the Joint Audit Committee (JAC)?
 5. What division at the CFTC is responsible for ensuring that DSROs are adequately supervising Futures Commission Merchants (FCMs)? What staff resources are dedicated to oversight of the self-regulatory organizations and designated self-regulatory organizations?
 6. What more should the CFTC do to ensure that designated self-regulatory organizations are properly supervising market participants?
2. Recently, the SEC approved Exchange Traded Funds (ETFs) backed by physical holdings of copper (BlackRock's iShares Copper Trust and J.P. Morgan's XF Physical Copper Trust). The SEC argued that the fund would not drive copper prices, but others have concerns that it could.
 - a. If your staff or anyone at the Commission has considered the extent to which these types of funds could have an impact on the price of physical products like copper or in CFTC-regulated markets, what have they concluded? Does the CFTC have sufficient access to data that would draw conclusions about this impact?

- b. The Dodd-Frank Act included language that requires additional consultation and coordination between the CFTC and the SEC. In March 2008, the agencies signed a Memorandum of Understanding that would facilitate more cooperation on issues of mutual interest. Given part of the CFTC's mission is to preserve the integrity of the price-discovery process in the futures, swaps, and options markets, and to protect these markets from manipulation, does the agency consider these physically-backed ETF approvals an area of mutual interest? Did the CFTC have any formal or informal input in the approvals of these ETFs? If the CFTC had input at any level, what communication did the agency have with the SEC or other regulators on this subject?
 - c. Does the CFTC currently have any authority to directly oversee these entities?
- 3. In a final position limits rule published in the Federal Register on November 18, 2011 (76 FR 71626), the CFTC discussed the treatment of commodity index funds. That final rule referenced a letter that then-Chairman of the Agriculture Committee Sen. Lincoln wrote to Chairman Gensler on December 16, 2010, that asked the agency to consider the impact of position limits on certain types of investment vehicles and classes of investors. Does the CFTC intend to propose a new rule on position limits and, if so, will the CFTC consider this letter and other comments provided to it at the time of its initial rulemaking on position limits?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the record
Senator Saxby Chambliss

Chairman Gensler:

1. In December, Mr. Masamichi Kono, Vice Commissioner for International Affairs for the Financial Services Agency of Japan testified before a House agriculture subcommittee. He noted *"In Japan, we have so far deliberately refrained from applying our rules to cross-border transactions in anticipation of an international coordination arrangement on regulation of cross-border transactions which we strongly hope to be developed soon."* On February 6th the Japanese Government again noted to you in a letter that *"We understand that the Commission intends to conduct assessment for substituted compliance with foreign regulatory requirements before the expiration date (July 12, 2013) of the final exemptive order. If, at the expiration date, substituted compliance with the Japanese regulatory requirements is not available for Japanese financial institutions which registered as swap dealers, they would be subject to the Commission's regulations after the expiration date."*

Are the concerns of Mr. Kono reflective of the concerns other foreign regulators?

Do you believe that by July 12th you will have cleared all of the issues the Japanese Government and other foreign regulators have brought to your attention?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
Questions for the record
February 27, 2013

Ranking Member Cochran

Hon. Gensler:

1. We continue to see concerns with the CFTC's data reporting requirements that conflict with some foreign countries' privacy laws, such as France, Singapore, Spain and Korea, among others. Market participants could be put in the difficult situation of failing to comply with CFTC regulations or violating another country's laws, subjecting them to criminal or civil penalties. Conflicts like these could cause firms in the United States doing business internationally to suffer financially. Such regulatory arbitrage would stunt financial growth, disrupt the markets, and go against this Administration's pledge to streamline and make regulations less burdensome for businesses. Can you outline your plan for resolving this and other similar situations where CFTC regulations and foreign country laws are in conflict?
 - a. Also, could you please explain how the CFTC has taken into consideration the Administration's pledge to streamline regulations like this so that the impact on firms is minimal?
 - b. If substituted compliance is not made available to international regulators, will the CFTC be extending the time period of its final exemptive rule for international entities, and if so, for how long?
2. How many meetings has the CFTC had with stakeholders, and particularly those involved in trading agricultural commodities, about how the Commission's "residual interest" provisions contained with your proposed customer protection rule will affect Futures Commission Merchants and their customers?
 - a. What are the changes in margin requirements the Commission is proposing in your proposed customer protection rule?
 - b. Does the Commodity Exchange Act provide for the CFTC to set margin requirements?
 - c. What is the statutory authority for the CFTC to mandate these changes?

- d. While this particular provision in the Commission's rule doesn't include a cost analysis, industry estimates indicate that it may result in customers of Futures Commission Merchants needing to hold an additional \$100 billion of their own funds in their margin accounts. Will the Commission be issuing a cost/benefit analysis for this specific provision of the rule?
 - e. Has the Office of Management and Budget indicated that the CFTC's "customer protection" rule will be a major rule?
3. During the hearing you indicated that the CFTC is actively shelving enforcement action(s) due to a lack of resources. Can you please provide a specific number of instances where this has occurred?
 4. Is it the CFTC's position that the industry—specifically members of a Designated Contract Market (DCM) that are not otherwise required to be registered with the CFTC—has been required to record and archive instant messages, text messages, and other forms of digital and electronic media based on the "industry guidance" that CFTC issued in 2009? If yes, are you suggesting that CFTC's 2009 "industry guidance" has the full force and effect of a regulation?
 - a. The expansion in the final rule specifically includes "voicemail" in the category of "written communication." Does this mean that the CFTC is taking the position that, if a phone call results in a voicemail, once it is recorded as a voicemail it is now a "written record" that must be maintained? Please explain the similarities and differences between the Securities and Exchange Commission's regulations and the CFTC's regulations regarding this topic.
 - b. If the appropriate policy regarding members of a DCM—that are not otherwise required to be registered with the CFTC—is to not require recording of oral communications related to cash commodity sales, does it make sense to make them retain the 21st century analogs for oral conversation, such as text messages and instant messages? What is the policy goal of this distinction?
 - c. In order to comply with the final rule as written, entities may have no choice but to avoid text or instant messaging, and simply go back to using the phone, which they do not have to record. Is this the intended policy outcome that the CFTC envisioned with this final rule?
 - d. Would the CFTC be willing to re-open that portion of the final rule on adaptation relating to what constitutes a "written record" in order to allow further industry comment?
 5. Does the Commission have enough information available to make a finding that position limits are necessary and appropriate?

6. Does the CFTC believe that the migration from swaps to futures is due to regulatory uncertainty or does this transition suggest that the Commission's rules are being promulgated in the wrong order?
7. Has the CFTC drafted any proposed technical changes or is the CFTC aware of any other federal agency that has drafted proposed changes to Title VII of Dodd-Frank? If so, can the CFTC please forward a copy of the draft to the Senate Agriculture Committee?
8. The CFTC's regulation of inter-affiliate trades is also a matter of great concern to companies in my state and across the country. Many such companies have established centralized treasury units to more efficiently manage their risk mitigation strategies. Is the CFTC considering denying end-user companies use of the clearing exception simply because they have adopted the use of inter-affiliate transactions or centralized treasury units as a type of risk mitigation? If so, can the CFTC fix this problem administratively or does Congress need to address this problem?
 - a. What is the CFTC's intended use for this captured inter-affiliate transaction data?
9. Based upon the GAO's January 23, 2013 response regarding the CFTC's reprogramming of funds obtained by eliminating two administrative law judges, two questions remain:
 - a. Have you reprogrammed the \$800,000 of funding saved from eliminating these jobs, and if so, how? Also, have you notified the House and Senate Appropriations Committees pursuant to the Act?
 - b. What authority allows you to eliminate these positions and contract judges?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the record

Senator Charles E. Grassley

Questions for Chairman Gary Gensler

QUESTION 1

Chairman Gensler, I want to thank you for reaching out to me regarding the manipulation of LIBOR. On February 21st in an interview with Bloomberg News, you referenced your concerns regarding the integrity of LIBOR saying that some might see the rate as “too big to replace” despite concerns about its integrity.

I am also concerned that some have taken this view of LIBOR. In addition to pegging LIBOR to real transactions, what suggestions would you make to create a sustainable benchmark rate that would not be so vulnerable to manipulation?

Are you concerned that we are in danger of reverting back to LIBOR without any meaningful reforms?

QUESTION 2

In a recent final rule, the CFTC recognized the compliance burden that the oral communications recordkeeping would have on smaller futures businesses, specifically excluding the requirement for Introducing Brokers that don't exceed a certain revenue threshold. Similarly, commercial grain elevators that largely deal in purchasing cash grain, occasionally take an order from a customer to hedge in the futures markets. Because they are technically a branch operation affiliated with a farmer cooperative futures commission merchant, and not an introducing broker, they will have to record all oral phone conversations. Given the low volume of futures transactions handled by these facilities, complying with such oral recording requirements under Regulation 1.35 could be difficult both economically and from a technical standpoint.

Given this situation, would CFTC consider treating those branch operations similar to small introducing brokers and exclude them from the oral communications recordkeeping requirements?

QUESTION 3

A lot is being discussed about customer protections in terms of regulations being implemented by the CFTC and some of the Self-Regulatory entities. In addition, customer protections will certainly come up during reauthorization of the Commodity Exchange Act. As we all know, the issue of customer protections is so prevalent because of the recent failures of Peregrine Financial and MF Global. Both of those firms are still going through the bankruptcy process.

It will be good for the Agriculture Committee to carefully consider proper customer protections during reauthorization of the Commodity Exchange Act; as the ranking member on the Judiciary Committee I am also interested in whether you think there are areas of the bankruptcy law that need to be analyzed as it pertains to protecting customers of futures brokerage firms which go into bankruptcy?

QUESTION 4

I support some of the recent work the CFTC has done in regards to increasing customer protections. That being said, I have heard from farmers and their brokers that they have serious concerns with the CFTC's proposed rule that would require futures brokerages to keep so-called residual interest in their accounts at all times to cover customers' margin requirements. Farmers are concerned about how this will effect the amount of money they would be required to keep in their margin accounts to cover possible moves in the market, whereas currently they provide more funds to cover movements in the market at the end of a given day. In addition there is concern with the practicality of farmers being able to get funds to their brokers potentially on a moment's notice in the middle of the day while they are busy running their farming operations.

I would like for you to put this proposed rule in the context of the recent collapse of futures brokers. In terms of the two biggest failures in the futures industry in recent years, MF Global and Peregrine Financial, could you explain if, and how, this so-called "residual interest" rule would have helped prevent the failures at MF Global and Peregrine Financial? How would this rule have helped protect customer money in those cases? If this proposed rule would not have had much affect in protecting customer money in MF Global or Peregrine Financial, could you please explain how the CFTC decided this proposed rule was necessary?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
2/27/13

Questions for the Record

Senator Tom Harkin

Questions for Chairman Gensler:

Question 1: At the request of the National Futures Association the Berkeley Research Group recently conducted an independent analysis of the NFAs auditing of Peregrine Financial Group, Inc. in light of the fraud perpetrated by Peregrine's CEO Russell Wasendorf Sr. The analysis included a list of recommendations that NFA has pledged to adopt.

Do you believe these changes are sufficient or that more needs to be done to ensure that the NFA is able to protect customer segregated funds and appropriately regulate the market participants that it oversees? If so, what additional steps do you believe need to be taken to fully protect customer segregated funds?

Question 2: One of the striking developments in the financial markets over the last decade is the rise of high speed trading. While there are many different views about the role that high speed trading plays in the market, in late 2012 CFTC Chief Economist Andrei Kirilenko published a study in which he found that High Frequency Traders generate their profits to the detriment of typical retail investors. This study followed on the joint report from the CFTC and SEC on the so-called "flash crash" that found high speed trading to be one of the causes of this significant market disruption that occurred on May 6, 2010. Finally the Financial Times recently noted that high speed trading is spreading into markets like bonds, currencies, and derivatives (Markets: In Search of a Fast Buck by Arash Massoudi and Michael Mackenzie, February 19, 2013).

In light of these events what do you believe the impact of high speed trading is on the safety and soundness of the financial system? What do you believe will be the impact of high speed trading in the derivatives markets?

Question 3: Title VII of the Dodd-Frank Act requires the CFTC to publicly report and take steps to protect the financial system should swaps that are required to clear not be cleared. As market participants are required to begin clearing certain swaps, what steps has the CFTC taken to implement the anti-evasion provisions of the Dodd-Frank Act?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
Questions for the record
Chairman Gensler
February 27, 2013

Senator Patrick Leahy

Questions for Chairman Gensler

I am hearing from a number of municipal electric utilities in Vermont, these are small, government-owned utilities, that are alarmed about new CFTC regulations they believe are preventing them from hedging fuel risks using financially settled contracts. These utilities are accountable to the people they serve and deeply invested in keeping their rates low and bills affordable to help stimulate the economic prosperity of the communities they serve.

As you mentioned in your testimony, the Dodd-Frank Act swaps market reforms were put in place to benefit end-users by lowering costs and increasing access to the markets. However I am concerned that our country's municipal utilities have been swept up in an unintended consequence in these regulations and these true end-users are being excluded from the swaps market because any counterparty that does business with them will be labeled a Swap Dealer.

I have heard from Vermont municipalities that are considered a "special entity" under your regulations who believe this has scared off any non-financial counterparty from doing business with them. This is limiting the ways they are able to hedge the price of fuel compared to other cooperatives or investor-owned utilities, which is putting the utilities and the communities they serve at a disadvantage.

The Dodd-Frank Act certainly did not intend for "end-users" such as municipal utilities to be frozen out of the swaps market like this. As I understand it there is no provision in that portion of the bill that required any kind of additional protections for special entities, so my question for you is how can this be fixed so that we are not unfairly discriminating against our municipal utilities?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
Wednesday, February 27, 2013
Questions for the record

Senator Thune

Hon. Gary Gensler

- 1) On the subject of the proposed customer-segregation rule, it is intended to prevent another collapse like MF Global or Peregrine Financial Group in which customer segregated funds are at risk. My concern is that the capital requirements are so stringent that smaller brokerages that cater to end-users in states like mine will not be able to survive, or at the very least will drive up costs for end-users like farmers, the very people this rule is intending to protect.

I understand that the comment period on this rule is now closed. Assuming you heard from end-users and brokerages concerned about the impact of this proposed rule, what steps are you taking to ensure those concerns are addressed before issuing a final rulemaking?

- 2) We've heard U.S. regulators talk about "international harmonization" and the belief that the rest of the world will follow, which played a role in the CFTC's delay in compliance with some of its cross-border derivatives rules last year. It is difficult to see that there will be such harmonization. Will you hit the pause button again as you did in October and in December? Isn't the better way to regulate to be clear that these requirements will be put on hold until an agreement is reached?
- 3) There has been a lot of focus in the industry press about so-called "futuresization" – that is the increased use of futures instead of swaps because of all the uncertainty surrounding the swaps rules, particularly in the energy space. It is interesting to see futuresization being made out to be a bad thing, because the futures are more highly regulated. But given the uncertainty with regard to swaps, and the piecemeal approach being taken in the implementation of the swaps rule, doesn't it make sense that folks would turn toward futures, even though they are more regulated, out of a desire for regulatory certainty?
- 4) The Commission has said that guarantees of swaps are themselves swaps. In addition to creating a great deal of uncertainty in areas such as cross-border jurisdiction and swap dealer and major swap participant calculations, this is directly contrary to what the SEC concluded in the same rulemaking, where they said guarantees of security based swaps are not themselves security based swaps. How is this consistent with the statutory

requirement that the two agencies coordinate their rules, and can you tell me where in the swap definition guarantees appear?

- 5) Why did the CFTC say that all options are swaps, ignoring the fact that Congress preserved the CFTC's existing authority over options? Why doesn't the Commission clarify that an option to buy a nonfinancial commodity – purchased by a commercial business that intends to use the product in its business, and not for financial speculation of any kind – is completely outside regulation as a swap?
- 6) Well before the April 10 reporting deadline, will the CFTC give guidance to end users on which volumetric options must be reported as swaps? And will this guidance clarify that options in a commercial forward that are used in the ordinary course of business, and not for financial speculation, are covered by the forward exemption?
- 7) There has been considerable debate around the intent of Sec. 722 of Dodd-Frank and the aggressive approach being taken by the CFTC to apply derivatives rules to U.S. banks doing business overseas with foreign clients. This approach has been criticized by market participants, and, maybe most noteworthy, foreign regulators as missing the mark and potentially exacerbating rather than ameliorating the problem. Given that foreign regulators have raised concerns about the potential application of Title VII in their jurisdictions, I am concerned about similar reciprocal measures being enacted by the E.U. or other foreign regulators in response. Can you please provide the Committee with details about how the agency intends to reach an agreement with the key European countries to resolve this dispute?
- 8) Given developments late last year – unnecessary disruptions around Oct. 12 deadlines, last minute "no-action" letters, reports that foreign banks wouldn't do business with US firms, an interim final rule, etc. – why should Congress have any level of confidence that you're moving in the right direction and that markets won't be negatively impacted by actions of the CFTC? Also, how do you intend on getting the rest of the world to follow the U.S. when the SEC and CFTC rules currently don't align on timing, process or content in many areas? What happens later this year if there is still not international harmonization or even domestic harmonization?
- 9) Why are such significant reforms – like your cross-border guidance – being made through guidance and no-action letters versus a formal rulemaking process? Is it to avert Administration Procedures Act (APA) requirements? Wouldn't all parties benefit from formally proposed rules?
- 10) A purpose of including the formation of Swap Execution Facilities in Dodd-Frank was to encourage price transparency, but there is nothing in the statute that directs the agencies to require a certain number of trade submissions as a prerequisite to qualify for trading as a SEF. In fact, the SEC's proposal does not have this requirement, so this clearly isn't a statutory necessity. But there is significant downside to mandating this

requirement. Requiring a certain number would reduce liquidity, increase trading costs and actually could impair transparency. Shouldn't we allow the SEF landscape to develop without imposing such inflexible requirements? If, as these platforms develop, the agency learns through experience that a minimum requirement is necessary, it can always revise the standards.

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

Chairwoman Debbie Stabenow

- 1.) The Board of the National Futures Association recently accepted recommendations provided by the Berkeley Research Group, LLC (BRG). NFA asked BRG to examine, in part, NFA's oversight of Peregrine Financial Group, Inc. before Peregrine's failure. The report discussed the NFA's relationship with the CFTC, recommended increased coordination between the NFA and the CFTC, and discussed NFA's oversight of market participants. The report highlighted what the NFA does well, but also made recommendations on how to improve NFA's audits.
- 2.) Does the CFTC have a written policy that dictates how and when information should be shared between the NFA and the CFTC, either at the staff level or otherwise? If not, why hasn't this been done? If so, please provide that policy to the Committee.

Response: The CFTC and the DSROs readily share information on firms and engage in routine meetings to discuss firms. All examination reports performed by the designated self-regulatory organizations (DSROs) are provided to the CFTC, and the CFTC is in the process of obtaining real-time access to the SROs' financial and compliance examinations

- a.) What is the CFTC's role in setting or approving designated self-regulatory organizations' (DSROs') auditing standards? If the agency has the authority to dictate auditing standards for DSROs, when did the agency last use this authority?
- b.) Has the agency ever formally examined the auditing standards of the NFA? If so, when is the last time this took place?

Response to 2(a) and 2(b): Last October, the Commission acted to propose new rules that are directed toward enhancing protections afforded customer funds held by Futures Commission Merchants and Derivatives Clearing Organizations. The proposal makes a number of changes that are designed to ensure that the Commission does everything within its authorities and resources to strengthen oversight programs and the protection of customers and their funds. Among the proposed reforms is a provision to set standards for the SROs' examinations and the annual certified financial statement audits, including raising minimum standards for independent public accountants who audit FCMs. The agency has received public comment regarding the proposed rules and will respond to those comments in issuing final rules.

- c.) What is the CFTC's relationship, formal or informal, with the Joint Audit Committee (JAC)?

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

Response: The CFTC is not a member of the JAC but participates in meetings at times depending on the agenda.

- d.) What division at the CFTC is responsible for ensuring that DSROs are adequately supervising Futures Commission Merchants (FCMs)? What staff resources are dedicated to oversight of the self-regulatory organizations and designated self-regulatory organizations?

Response: The Division of Swap Dealer and Intermediary Oversight (DSIO) oversees the DSROs and exercises supervision over Futures Commission Merchants (FCMs). DSIO has two people dedicated full time to overseeing the DSROs. They are supplemented with other DSIO staff when the need arises to support an examination of the DSRO.

- e.) What more should the CFTC do to ensure that designated self-regulatory organizations are properly supervising market participants?

Response: The CFTC's mission is to ensure the integrity of the futures and swaps markets. As part of this, we must do everything within our authorities and resources to strengthen oversight programs and the protection of customers and their funds. That's the goal of rules proposed by the Commission last year. It's about ensuring customers have confidence that the funds they post as margin or collateral are fully segregated and protected.

CFTC Commissioners and staff reached out broadly on ways to enhance customer protections. We hosted two roundtables on issues ranging from the segregation of customer funds to examining the CFTC's oversight of self-regulatory organizations (SROs). In July, the CFTC approved a National Futures Association (NFA) proposal that stemmed from a coordinated effort by the CFTC, the SROs, other financial regulators, and market participants, including from CFTC roundtables.

The CFTC's November 2012 customer protection proposal addresses several components of customer protection, including the self-regulatory organization oversight program, risk disclosures, financial reporting, and public disclosures.

With respect to the SRO financial surveillance program, the proposal would require SROs that examine FCMs, including the NFA, to establish a supervisory program that, among other things, must be based on controls testing as well as substantive testing, and must address all areas of risk that the FCM can reasonably foresee. The supervisory program also must have standards addressing such issues as the ethics of the examiner; the independence of the examiner; the supervision, review, and quality control of an examiner's work product; and the quality control procedures to ensure that the examinations maintain the level of quality expected. The SROs also would be required to engage a recognized accounting or auditing firm with substantial expertise in the audit of

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

FCMs, risk assessment, and internal control reviews to evaluate the SROs' supervisory program and the application of the of the supervisory program at least once every two years.

The Commission received more than 100 comment letters on the proposed customer protection rulemaking. Staff is currently reviewing the comments and the Commission will respond in a final rule.

- 3.) Recently, the SEC approved Exchange Traded Funds (ETFs) backed by physical holdings of copper (BlackRock's iShares Copper Trust and J.P. Morgan's XF Physical Copper Trust). The SEC argued that the fund would not drive copper prices, but others have concerns that it could.
- a.) If your staff or anyone at the Commission has considered the extent to which these types of funds could have an impact on the price of physical products like copper or in CFTC-regulated markets, what have they concluded? Does the CFTC have sufficient access to data that would draw conclusions about this impact?
 - b.) The Dodd-Frank Act included language that requires additional consultation and coordination between the CFTC and the SEC. In March 2008, the agencies signed a Memorandum of Understanding that would facilitate more cooperation on issues of mutual interest. Given part of the CFTC's mission is to preserve the integrity of the price-discovery process in the futures, swaps, and options markets, and to protect these markets from manipulation, does the agency consider these physically-backed ETF approvals an area of mutual interest? Did the CFTC have any formal or informal input in the approvals of these ETFs? If the CFTC had input at any level, what communication did the agency have with the SEC or other regulators on this subject?
 - c.) Does the CFTC currently have any authority to directly oversee these entities?

Response to (a), (b), and (c): While the CFTC is not a price setting agency, the Commission has the responsibility for the oversight of commodities trading on regulated markets that are subject to the Commission's regime. The Commodity Exchange Act requires the registration of Commodity Pool Operators (CPOs) including CPOs that offer commodity pools whose shares are publicly offered and listed for trading on a national securities exchange. Like ETFs generally, these commodity ETFs may passively seek to track or replicate the performance of a specific commodity or commodity index or they may actively trade commodity interests. To the extent that such pools are fully regulated by the

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934, the CFTC has recognized the SEC regime as providing investor protection and granted relief from duplicative requirements such as the manner in which required CPO disclosures are provided in connection with investor prospectuses.

Through its large trader reporting system, the CFTC obtains position information for traders whose positions in futures contracts and in options on futures contracts exceed specified levels. To the extent the ETF, as a commodity pool, has a reportable position, it is subject to the CFTC's large trader reporting regime.

Some ETFs are structured in such a way that their shares may not be securities, but cash market transactions. These "physical commodity-based ETFs" hold physical commodities, such as gold or silver, rather than futures or commodity options. To date, these ETFs have listed their shares on national securities exchanges subject to SEC regulation. National securities exchanges have also elected to list options and security futures on such shares; however, to the extent such a product is a commodity options or futures contract, it is subject to the CEA's requirement that it be traded on a CFTC-designated market. The CFTC has provided exemptive relief to such products in recognition of the fact that they are subject to the SEC's regime of customer protection. Staff from the SEC's Division of Trading and Markets (T&M) have engaged with the CFTC's Division of Market Oversight (DMO) with respect to the various viewpoints in comment letters that were submitted to the SEC on the copper ETF proposals.

- 4.) In a final position limits rule published in the Federal Register on November 18, 2011 (76 FR 71626), the CFTC discussed the treatment of commodity index funds. That final rule referenced a letter that then-Chairman of the Agriculture Committee Sen. Lincoln wrote to Chairman Gensler on December 16, 2010, that asked the agency to consider the impact of position limits on certain types of investment vehicles and classes of investors. Does the CFTC intend to propose a new rule on position limits and, if so, will the CFTC consider this letter and other comments provided to it at the time of its initial rulemaking on position limits?

Response: The CFTC has appealed the September 28, 2012, Order of the District Court for the District of Columbia that vacated the position limits final rule. In addition, staff is developing a draft of a new proposed rule for consideration by the Commission. The Commission will benefit from prior comments, as well as new comments that may be received.

Ranking Member Thad Cochran

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

- 1.) We continue to see concerns with the CFTC's data reporting requirements that conflict with some foreign countries' privacy laws, such as France, Singapore, Spain and Korea, among others. Market participants could be put in the difficult situation of failing to comply with CFTC regulations or violating another country's laws, subjecting them to criminal or civil penalties. Conflicts like these could cause firms in the United States doing business internationally to suffer financially. Such regulatory arbitrage would stunt financial growth, disrupt the markets, and go against this Administration's pledge to streamline and make regulations less burdensome for businesses. Can you outline your plan for resolving this and other similar situations where CFTC regulations and foreign country laws are in conflict?
 - a.) Also, could you please explain how the CFTC has taken into consideration the Administration's pledge to streamline regulations like this so that the impact on firms is minimal?
 - b.) If substituted compliance is not made available to international regulators, will the CFTC be extending the time period of its final exemptive rule for international entities, and if so, for how long?

Response: In implementing the requirements of the Dodd-Frank Act, the CFTC has engaged in discussions with foreign regulatory authorities and market participants to coordinate and promote consistent standards wherever possible. CFTC staff also shared drafts of term sheets, proposed rulemakings and interpretive guidance, and other relevant working documents with domestic and foreign authorities. CFTC Commissioners and staff have also solicited public feedback by conducting meetings, conference calls, roundtables and by participating in panels, hearings and other public events. The Commission considers such feedback carefully in order to finalize and implement its regulations and guidance. The Commission will continue to engage with foreign regulatory authorities and the public.

With respect to data reporting requirements, in a December 3, 2012 letter, the International Swaps and Derivatives Association, Inc., on behalf of its members requested targeted relief from certain requirements of the reporting rules. In the letter, ISDA stated that there exist potential conflicts between the Commission's reporting rules and the privacy laws of certain non-U.S. jurisdictions. ISDA represented that these privacy laws may, in certain circumstances, restrict or prohibit the disclosure of a non-reporting party's identity information by a reporting party. ISDA further represented that depending on the non-U.S. jurisdiction, disclosure of identity information may require non-reporting party consent, regulatory authorization, or both. The Division of Market Oversight granted ISDA's request for targeted relief from certain reporting obligations. Since then, the Commission has continued to engage with authorities and others and is considering whether or not this targeted relief should be extended. Similar discussions and

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

considerations extend to the duration and substance of the final exemptive order regarding compliance with certain swap regulations with respect to cross-border swaps activities.

- 2.) How many meetings has the CFTC had with stakeholders, and particularly those involved in trading agricultural commodities, about how the Commission's "residual interest" provisions contained with your proposed customer protection rule will affect Futures Commission Merchants and their customers?

Response: Commission staff have discussed the potential impact of the residual interest provisions with representatives from a number of organizations including the American Farm Bureau Federation, the National Grain and Feed Association, the National Council of Farmer Cooperatives, the National Pork Producers Council, the Futures Industry Association, the International Swaps and Derivatives Association, Inc., and ADM Investor Services. In addition, the Commission held a public roundtable on February 5, 2013, to discuss, among other topics, the proposed residual interest provisions. Participants on the residual interest panel included representatives from a clearinghouse, from futures commission merchants and from the buy-side, including representatives from RJ O'Brien & Associates, Inc., the National Pork Producers Council, the National Grain and Feed Association, and the Commodity Customer Coalition. Representatives from the American Feed Industry Association, the Commodity Markets Council, and New England Fuel Institute were invited but unable to participate.

- a.) What are the changes in margin requirements the Commission is proposing in your proposed customer protection rule?
- b.) Does the Commodity Exchange Act provide for the CFTC to set margin requirements?
- c.) What is the statutory authority for the CFTC to mandate these changes?
- d.) While this particular provision in the Commission's rule doesn't include a cost analysis, industry estimates indicate that it may result in customers of Futures Commission Merchants needing to hold an additional \$100 billion of their own funds in their margin accounts. Will the Commission be issuing a cost/benefit analysis for this specific provision of the rule?

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

Response to (a), (b), (c) and (d): Section 4d(a)(2) of the Commodity Exchange Act states that the money, securities, and property received by a futures commission merchant from a customer to margin, guarantee, or secure the trades or contracts of that customer “shall be separately accounted for and shall not be commingled with the funds of such commission merchant or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held.” Similarly section 4d(f)(2) of the Commodity Exchange Act prohibits a futures commission merchant from using the money, securities, and property of a swaps customer to margin, guarantee, or secure any trades or contracts of “of any customer or person other than the one for whom the same are held.” Finally, Commission regulation 1.22, which has existed since the 1980s, states that “No futures commission merchant shall use, or permit the use of, the futures customer funds of one futures customer to purchase, margin, or settle the trades, contracts, or commodity options of, or to secure or extend the credit of, any person other than such futures customer,” and Commission regulation 22.2(d)(1) states that “No futures commission merchant shall use, or permit the use of, the Cleared Swaps Customer Collateral of one Cleared Swaps Customer to purchase, margin, or settle the Cleared Swaps or any other trade or contract of, or to secure or extend the credit of, any person other than such Cleared Swaps Customer.”

In its recent review of the Commission’s customer protection regime, Commission staff realized that there were market practices that were in tension with the plain language of the Commodity Exchange Act and Commission regulations. As such, the Commission proposed a regulation to clarify acceptable practices with respect to these existing statutory and regulatory requirements. The Commission has received public comments regarding the proposed rule and will consider and respond to them in connection with the final rule.

The Commission takes very seriously the consideration of costs and benefits of the rules it considers as required under section 15(a) of the Commodity Exchange Act. The economic costs and benefits associated with regulations, especially as they pertain to commenters’ concerns, are of utmost importance in the Commission’s deliberation and determination of final rules.

- e.) Has the Office of Management and Budget indicated that the CFTC’s “customer protection” rule will be a major rule?

Response: The OMB determination will be made in connection with the final rule.

- 3.) During the hearing you indicated that the CFTC is actively shelving enforcement action(s) due to a lack of resources. Can you please provide a specific number of instances where this has occurred?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

Response: We are constantly faced, as any law enforcement agency is, with making priorities as to which cases to pursue. But what we have found, because of the financial crisis of 2008 and because of the passage of Dodd-Frank and some of the changes in the marketplace, that we're increasingly faced with complex cases, complex investigations, and we don't have sufficient staff to address them.

- 4.) Is it the CFTC's position that the industry—specifically members of a Designated Contract Market (DCM) that are not otherwise required to be registered with the CFTC—has been required to record and archive instant messages, text messages, and other forms of digital and electronic media based on the “industry guidance” that CFTC issued in 2009? If yes, are you suggesting that CFTC's 2009 “industry guidance” has the full force and effect of a regulation?

Response: In 2009, the Commission's Division of Market Oversight (DMO) issued an Advisory to clarify certain Commission recordkeeping requirements pertaining to futures commission merchants (FCMs), introducing brokers (IBs), and members of a designated contract market. The Advisory was to clarify that the individuals and entities subject to the Commission's recordkeeping requirements should maintain all electronic forms of communications, including email, instant messages, and any other form of communication created or transmitted electronically for all trading. Also noted in the Advisory is that recordkeeping regulations do not distinguish between methods used to record the information covered by the regulations, including emails, instant messages, and any other form of communication created or transmitted electronically. The Commission adopted the proposed amendment to regulation 1.35(a) to clarify that the existing requirement to keep written records applies to electronic written communications, such as emails and instant messages.

- a.) The expansion in the final rule specifically includes “voicemail” in the category of “written communication.” Does this mean that the CFTC is taking the position that, if a phone call results in a voicemail, once it is recorded as a voicemail it is now a “written record” that must be maintained? Please explain the similarities and differences between the Securities and Exchange Commission's regulations and the CFTC's regulations regarding this topic.

Response: The amended regulation provides that among the records required to be kept are all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest and related cash or forward transactions, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media. The final rule does not specifically include “voicemail” in the category of written communication but provides a list of

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

included modes of communication in the requirement that "all oral and written communications" be kept.

- b.) If the appropriate policy regarding members of a DCM—that are not otherwise required to be registered with the CFTC—is to not require recording of oral communications related to cash commodity sales, does it make sense to make them retain the 21st century analogs for oral conversation, such as text messages and instant messages? What is the policy goal of this distinction?
- c.) In order to comply with the final rule as written, entities may have no choice but to avoid text or instant messaging, and simply go back to using the phone, which they do not have to record. Is this the intended policy outcome that the CFTC envisioned with this final rule?

Response to (b) and (c): The overarching purpose of the Commission's final rule is to promote market integrity and protect customers. Requiring the recording and retention of oral communications will serve as a disincentive for covered entities to make fraudulent or misleading communications. In response to comments asserting that the cost of implementing and maintaining an oral communication recording system would be overly burdensome for small entities and the commercial end-user, non-intermediary members of a DCM or SEF, the Commission has determined to exclude from the new oral communications requirement members that are not registered or required to be registered with the Commission in any capacity.

- d.) Would the CFTC be willing to re-open that portion of the final rule on adaptation relating to what constitutes a "written record" in order to allow further industry comment?

Response: The Commission is not proceeding at this time to re-open the rule.

- 5.) Does the Commission have enough information available to make a finding that position limits are necessary and appropriate?

Response: The Commission interprets the meaning of section 4a(a) of the Commodity Exchange Act to mandate that the Commission impose position limits on futures contracts, options, and certain swaps in physical commodities.

- 6.) Does the CFTC believe that the migration from swaps to futures is due to regulatory uncertainty or does this transition suggest that the Commission's rules are being promulgated in the wrong order?

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

Response: The swaps market emerged in the 1980s, but until now, it lacked the benefit of futures and securities market rules that have served to promote transparency, lower risk and protect investors. What followed was the 2008 financial crisis, which was caused in part by the swaps markets. Eight million American jobs were lost. In contrast, the futures market, supported by earlier reforms, weathered the financial crisis. Now that the entire derivatives marketplace – both futures and swaps – has comprehensive oversight, it's the natural order of things for some realignment to take place.

The notional open interest of the futures market ranges around \$30 trillion. There are various estimates for the notional size of the U.S. swaps market, but it ranges around \$250 trillion. Though the futures market trades more actively, just one-ninth or so of the combined open interest in the derivatives marketplace is futures. Approximately eight-ninths of the combined derivatives marketplace is swaps, which until recently were unregulated.

Last fall, IntercontinentalExchange converted power and natural gas-related swaps into futures contracts. In addition, the CME Group's ClearPort products, which were cleared as futures, including those that were executed bilaterally as swaps, are now being offered for trading on Globex or on the trading floor. CME also adopted new block trading rules for its ClearPort energy contracts, and it began trading a futures contract where the underlying product is an interest rate swaps contract.

Whether one calls a product a standardized swap or a future, both markets will now benefit from central clearing. In addition, transparency has been a longstanding hallmark of the futures market – both pre-trade and post-trade. Now, for the first time, the swaps market is benefitting from post-trade transparency, and the Commission has adopted pre-trade transparency rules as well.

- 7.) Has the CFTC drafted any proposed technical changes or is the CFTC aware of any other federal agency that has drafted proposed changes to Title VII of Dodd-Frank? If so, can the CFTC please forward a copy of the draft to the Senate Agriculture Committee?

Response: The Commission has not proposed technical changes to date but is always available to provide technical assistance.

- 8.) The CFTC's regulation of inter-affiliate trades is also a matter of great concern to companies in my state and across the country. Many such companies have established centralized treasury units to more efficiently manage their risk mitigation strategies. Is the CFTC considering denying end-user companies use of the clearing exception simply because they have adopted the use of inter-affiliate transactions or centralized treasury units as a type of

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

risk mitigation? If so, can the CFTC fix this problem administratively or does Congress need to address this problem?

a.) What is the CFTC's intended use for this captured inter-affiliate transaction data?

Response: Under the Dodd-Frank Act, an end-user is exempt from the clearing requirement if it is not a financial entity, and is using swaps to hedge or mitigate commercial risk.

The Commission has approached swaps market reform with an eye toward ensuring a market that works well for end-users, America's job providers. Congress provided in Dodd-Frank that end-users should be able to choose whether or not to clear swaps that hedge or mitigate commercial risks. Last summer, the Commission finalized rules to implement this exception.

The CFTC also finalized a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement.

We've received many comments and had many meetings with non-financial end-users that about required clearing if they use a treasury affiliate when entering into their market facing swaps.

The staff and Commission are taking a close look at how to appropriately address these issues in the context of the Dodd-Frank Act.

9.) Based upon the GAO's January 23, 2013 response regarding the CFTC's reprogramming of funds obtained by eliminating two administrative law judges, two questions remain:

a.) Have you reprogrammed the \$800,000 of funding saved from eliminating these jobs, and if so, how? Also, have you notified the House and Senate Appropriations Committees pursuant to the Act?

Response: By letter of April 15, 2013, I notified the Committees on Appropriations that the Commission intends to reprogram \$755,109 in savings from the ALJ program for the Division of Enforcement's work to protect market participants and other members of the public from fraud, manipulation and other abusive practices in the commodities, futures and swaps markets.

b.) What authority allows you to eliminate these positions and contract judges?

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

Response: The following insert is the memorandum from the agency's General Counsel and the agency's Chief Human Capital Officer dated August 9, 2011:



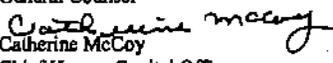
Office of Human
Resources

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5003
Facsimile: (202) 418-5530

INFORMATION MEMORANDUM

TO: The Commission

FROM: Dan M. Berkovitz 
General Counsel
Catherine McCoy 
Chief Human Capital Officer

DATE: August 9, 2011

SUBJECT: Legal authority to separate Administrative Law Judges by Reduction in Force, to remove monetary limit on the Judgment Officer's jurisdiction, and to receive services of Administrative Law Judges through details from other agencies

RESPONSIBLE STAFF: Jonathan Marcus, Deputy General Counsel
Ralph Avery, Assistant General Counsel
Vivian Jarcho, Chief of Workforce Relations
Lauren Colon, Human Resources Specialist

Introduction

The legal issues addressed in this memorandum have arisen from a prolonged, substantial decrease in the utilization of the agency's two administrative law judges ("ALJs"). This has led the agency to consider the following options for changing the organizational structure of the Office of Proceedings: (1) Reduction in Force ("RIF") with respect to the two ALJs, eliminate the current ceiling of \$30,000 on non-consensual use of a Judgment Officer ("JO") to resolve reparations cases, and reorganize the Office of Proceedings, as necessary, or (2) RIF with respect

to the two ALJs, retain the current ceiling of \$30,000 on non-consensual use of the JO to resolve reparations cases, and retain outside ALJs on an as-needed basis to handle reparations cases above \$30,000, again reorganizing the Office of Proceedings as necessary. Both options would use outside ALJs to handle other proceedings, such as enforcement cases, for which ALJs are currently available.

This memorandum only addresses the legal aspects of these options. Organizational and cost issues are addressed in a separate memorandum from the agency's Chief Financial Officer.

Summary of Legal Conclusions

The Commission has the legal authority to separate ALJs by RIF due to a substantial, prolonged decline in workload. The Commission has statutory discretion to specify which reparations cases will be heard by a JO, without regard to monetary amount. The Commission also has statutory authority to obtain services of other agencies' ALJs through details on an as-needed basis, a practice that is common in the federal government.

Discussion

1. The Reduction in Force regulations apply to Administrative Law Judges.

The appointment and continued employment of ALJs is governed by 5 CFR § 930, Subpart B. ALJs generally enjoy substantial additional employment protections, compared to non-adjudicatory personnel, to preserve their independence. For example, the hiring process for ALJs is administered by the Office of Personnel Management ("OPM") rather than individual agencies, and ALJs do not receive performance evaluations or performance awards. ALJs are, however, still subject to many of the personnel regulations applicable to federal employees in general.

Among the regulations applicable to all employees, including ALJs, are those governing RIFs at 5 CFR § 351. The employment regulations for ALJs explicitly provide for the application of the RIF regulations. 5 CFR § 930.210(a). There are only two significant variations from the RIF procedures for ALJs: (1) performance ratings are not considered in determining the retention standing of ALJs because they do not receive performance ratings, and (2) placement assistance, in addition to what the agency provides, is given by OPM. Neither of these variations diminishes the Commission's authority to implement a RIF.

2. The Commission is not required to seek the permission of the Merit Systems Protection Board before proceeding.

Among the additional protections provided to ALJs is a requirement that most adverse personnel actions be taken only for good cause as determined by the Merit Systems Protection Board ("MSPB") after an opportunity for a hearing. 5 CFR § 930.211. However, these procedures do not apply to all personnel actions against ALJs. Specifically, the MSPB has original jurisdiction over removal, suspension, reduction in grade, reduction in pay, and furloughs of 30 days or less. 5 C.F.R. § 1201.137. RIFs are not covered actions under these regulations, and ALJs are not entitled to a pre-RIF hearing and decision from the MSPB.

Separations from federal service, when effected through RIFs, are appealable to the MSPB after the personnel action is taken. 5 CFR § 1201.3(a)(10). ALJs possess the same appeal rights to the MSPB that apply to all federal employees subject to RIFs. These procedures entitle ALJs to a de novo review of the RIF, including discovery and a hearing, to ensure that the agency conducted the RIF appropriately.

3. The Commission has statutory authority to remove the monetary limit on the Judgment Officer's jurisdiction.

Section 14(b) of the Commodity Exchange Act ("CEA") authorizes the Commission to promulgate rules, regulations, and orders as it deems necessary or appropriate for the efficient and expeditious administration of its reparations program. Rule 12.26(c) currently provides that formal decisional proceedings are to be conducted by an ALJ. A formal decisional proceeding is held when the amount claimed in damages exceeds \$30,000 and the parties have not elected a voluntary decisional proceeding under Subpart C of the Commission's Part 12 rules. Voluntary decisional proceedings are heard by a JO without regard to the amount in controversy under Rule 12.26(a). Cases where the amount in controversy is less than \$30,000 are conducted as summary decisional proceedings by a JO under Subpart D, as provided in Rule 12.26(b).

The Commission has, from time to time, raised the ceiling for claims eligible to be heard as summary proceedings from \$2,500 to \$5,000 to \$10,000 and then to \$30,000. Rules Relating to Reparation Proceedings, 59 Fed. Reg. 9631, 9633 (Mar. 1, 1994) (increasing the ceiling to \$30,000 and otherwise amending Part 12). There is nothing in the CEA requiring any monetary limit on the JO's authority, and, as noted above, the JO presently hears disputes involving matters in excess of \$30,000 with the consent of the parties. The \$30,000 limit is, in a certain sense, arbitrary, because the dollar value of a claim is not a reliable indicator of its legal or factual complexity.

The Administrative Procedure Act, 5 U.S.C. § 553, generally requires notice of proposed rulemaking and provides for public participation. Section 553 does, however, exempt from these requirements "rules of agency organization, procedure or practice," for which the agency has discretion not to provide notice. The Commission could determine that making this change effective immediately, without public notice and comment, would promote efficiency and

facilitate the Commission's core mission without imposing a new burden on the public or on participants in the reparations program.

4. ALJs may be detailed to the agency as needed.

Section 3344 of Title 5 of the U.S. Code provides express statutory authority for ALJs assigned to one agency to provide services to another agency under a detail. *See also* 5 C.F.R. § 930.208. Authority to reimburse the lending agency for the services of an ALJ detailed to the Commission is found in the Economy Act, 31 U.S.C. § 1535. This practice is common in the federal government, as several agencies, such as the MSPB, the Coast Guard, and the Equal Employment Opportunity Commission routinely receive ALJ services under details. Thus, the Commission could simply request ALJs' services as needed for formal decisional proceedings conducted pursuant to Rule 12.26(c) as an alternative to removing the monetary limit on the JO's jurisdiction.

cc:
Eric Juzenas, Senior Counsel

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

Senator Patrick Leahy

- 1.) I am hearing from a number of municipal electric utilities in Vermont, these are small, government-owned utilities, that are alarmed about new CFTC regulations they believe are preventing them from hedging fuel risks using financially settled contracts. These utilities are accountable to the people they serve and deeply invested in keeping their rates low and bills affordable to help stimulate the economic prosperity of the communities they serve.
- 2.) As you mentioned in your testimony, the Dodd-Frank Act swaps market reforms were put in place to benefit end-users by lowering costs and increasing access to the markets. However I am concerned that our country's municipal utilities have been swept up in an unintended consequence in these regulations and these true end-users are being excluded from the swaps market because any counterparty that does business with them will be labeled a Swap Dealer.
- 3.) I have heard from Vermont municipalities that are considered a "special entity" under your regulations who believe this has scared off any non-financial counterparty from doing business with them. This is limiting the ways they are able to hedge the price of fuel compared to other cooperatives or investor-owned utilities, which is putting the utilities and the communities they serve at a disadvantage.
- 4.) The Dodd-Frank Act certainly did not intend for "end-users" such as municipal utilities to be frozen out of the swaps market like this. As I understand it there is no provision in that portion of the bill that required any kind of additional protections for special entities, so my question for you is how can this be fixed so that we are not unfairly discriminating against our municipal utilities?

Response: The final rule adopted jointly by the CFTC and the SEC to further define the term "swap dealer" provides that a person shall not be deemed a swap dealer if swap dealing activity for the preceding 12 months results in swap positions with an aggregate gross notional amount of no more than \$3 billion, and an aggregate gross notional amount of no more than \$25 million with regard to swaps with a "special entity" (which includes municipalities, other political subdivisions and employee benefit plans). The rule also provides for a phase-in of the de minimis threshold to facilitate orderly implementation of swap dealer requirements. During the phase-in period, the de minimis threshold would effectively be \$8 billion (while the \$25 million threshold for swaps with special entities would apply).

In developing the rule further defining the term "swap dealer" and other rules under the Dodd-Frank Act that may affect municipal utilities, CFTC Commissioners and

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

staff met with municipal utility representatives and their advisors and counterparties regarding their concerns. The final joint rule contains a provision that excludes from the calculation certain swaps entered into for the purpose of hedging physical positions. In addition, on October 12, 2012, Commission staff issued no-action relief, which states that staff will not recommend enforcement action if non-financial entities enter into swaps as part of a swap dealing business with utility special entities (such as municipal utilities) with a notional value of up to \$800 million annually without registering as a swap dealer. By its terms, the no-action relief will remain in effect until Commission action is completed on a petition submitted by public utilities requesting an amendment to the rule to exclude from the special entity de minimis threshold relevant swap contracts relating to utility operations.

Congress also authorized the CFTC to provide relief from the Dodd-Frank Act's swaps reforms for certain electricity and electricity-related energy transactions between rural electric cooperatives and federal, state, municipal and tribal power authorities. Similarly, Congress authorized the CFTC to provide relief for certain transactions on markets administered by regional transmission organizations and independent system operators. The recently finalized exemptive orders related to these transactions, as Congress authorized.

Senator Tom Harkin

- 1.) At the request of the National Futures Association the Berkeley Research Group recently conducted an independent analysis of the NFAs auditing of Peregrine Financial Group, Inc. in light of the fraud perpetrated by Peregrine's CEO Russell Wasendorf Sr. The analysis included a list of recommendations that NFA has pledged to adopt.
 - a.) Do you believe these changes are sufficient or that more needs to be done to ensure that the NFA is able to protect customer segregated funds and appropriately regulate the market participants that it oversees? If so, what additional steps do you believe need to be taken to fully protect customer segregated funds?

Response: The Berkeley Research Group (BRG) was retained by the National Futures Association (NFA) to conduct an independent review of the NFA audit practices and procedures for futures commission merchants (FCMs), and the execution of those procedures in the specific instances of Peregrine Financial Group, Inc. (PFG), to assure that adequate procedures are in place and that they are being followed properly. BRG issued its report on the investigation of NFA audit practices and procedures in January 2013.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

BRG provided 21 recommendations designed to improve the operations of the NFA audits based upon the findings set forth in its report.

In November 2012, the Commission issued for public comment a comprehensive set of proposed amendments to its regulations to enhance protections provided to customers. The proposed amendments address several components of customer protection, including the self-regulatory organization oversight program, risk disclosures, financial reporting, and public disclosures.

With respect to the self-regulatory organization financial surveillance program, the proposal would require self-regulatory organizations that examine FCMs, including the NFA, to establish a supervisory program that, among other things, must be based on controls testing as well as substantive testing, and must address all areas of risk that the FCM can reasonably foresee. The supervisory program also must have standards addressing such issues as the ethics of the examiner; the independence of the examiner; the supervision, review, and quality control of an examiner's work product; and the quality control procedures to ensure that the examinations maintain the level of quality expected. Each self-regulatory organization also would be required to engage a recognized accounting or auditing firm with substantial expertise in the audit of FCMs, risk assessment, and internal control reviews to evaluate the SRO's supervisory program and the application of the of the supervisory program at least once every two years.

The Commission received more than 100 comment letters on the proposed customer protection rulemaking. Staff is currently reviewing the comments, and the Commission will respond in a final rule.

- 2.) One of the striking developments in the financial markets over the last decade is the rise of high speed trading. While there are many different views about the role that high speed trading plays in the market, in late 2012 CFTC Chief Economist Andrei Kirilenko published a study in which he found that High Frequency Traders generate their profits to the detriment of typical retail investors. This study followed on the joint report from the CFTC and SEC on the so-called "flash crash" that found high speed trading to be one of the causes of this significant market disruption that occurred on May 6, 2010. Finally the Financial Times recently noted that high speed trading is spreading into markets like bonds, currencies, and derivatives (Markets: In Search of a Fast Buck by Arash Massoudi and Michael Mackenzie, February 19, 2013).

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

- a.) In light of these events what do you believe the impact of high speed trading is on the safety and soundness of the financial system? What do you believe will be the impact of high speed trading in the derivatives markets?

Response: One thing we can be quite sure of is that means of communication and technology will continue to advance and affect our markets. This was true in the 19th century when the telegraph led to the introduction of the ticker tape. This also was true in the early 20th century when telephones first allowed a central quote system where market participants could get instantaneous bid and ask prices. It was true during the last decade when the futures markets went from largely open outcry to now approximately 90 percent electronically traded.

Where market makers used to be on the floor of the exchanges, they now often sit at computers miles away or even on another continent. While market participants used to be involved in each of their trades, they now often rely on algorithms to execute their trades. Humans are much more frequently relying on the judgment programmed into machines to initiate and execute their trading strategies. The markets have evolved to where we increasingly find machines competing with each other.

To give hedgers and investors confidence in markets, our regulations have to adapt to markets that are increasingly moving from man to machine. Regulators cannot assume that the algorithms in the markets are well designed, tested or supervised. Only through adaptive regulation can hedgers and investors have confidence in the markets and market integrity. The Commission will continue working to adapt our oversight to changing market structure, including emerging trends related to electronic trading. The Commission has already taken a number of steps, and the CFTC's Technology Advisory Committee (TAC) has been helping to inform us as we move forward. As it relates to both trading and clearing, the Commission has adopted rules for pre-trade filters to protect the markets and the clearing system. This was achieved in the final rules for designated contract markets and risk management for clearing members.

The Commission also is reviewing a rule on the reporting of ownership and control information for trading accounts. These rules would enhance the Commission's surveillance capabilities and increase the transparency of trading to the Commission.

Further, I expect the Commission to soon consider a draft concept release on risk controls and system safeguards for electronic trading platforms, automated trading systems, clearing firms and other market participants in the evolving market for U.S. derivatives trading. The concept release would offer the broader public an opportunity to give the Commission advice on technology-driven changes in Commission regulated markets.

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

- 3.) Title VII of the Dodd-Frank Act requires the CFTC to publicly report and take steps to protect the financial system should swaps that are required to clear not be cleared. As market participants are required to begin clearing certain swaps, what steps has the CFTC taken to implement the anti-evasion provisions of the Dodd-Frank Act?

Response: The Commission issued regulation 50.10 to prevent evasion of the clearing requirement and related provisions and abuse of any exemption or exception to the clearing requirement under the Dodd-Frank Act. Both cleared and un-cleared swaps are required to be reported to Swap Data Repositories.

Senator Saxby Chambliss

- 1.) In December, Mr. Masamichi Kono, Vice Commissioner for International Affairs for the Financial Services Agency of Japan testified before a House agriculture subcommittee. He noted *"In Japan, we have so far deliberately refrained from applying our rules to cross-border transactions in anticipation of an international coordination arrangement on regulation of cross-border transactions which we strongly hope to be developed soon."* On February 6th the Japanese Government again noted to you in a letter that *"We understand that the Commission intends to conduct assessment for substituted compliance with foreign regulatory requirements before the expiration date (July 12, 2013) of the final exemptive order. If, at the expiration date, substituted compliance with the Japanese regulatory requirements is not available for Japanese financial institutions which registered as swap dealers, they would be subject to the Commission's regulations after the expiration date."*

Are the concerns of Mr. Kono reflective of the concerns other foreign regulators?

Do you believe that by July 12th you will have cleared all of the issues the Japanese Government and other foreign regulators have brought to your attention?

Response: Japan and other jurisdictions have provided comments on the CFTC's proposed approach to the regulation of cross-border transactions, and Commissioners and staff have met on numerous occasions with foreign regulators to discuss mutual concerns.

The CFTC and the SEC have convened a series of meetings with market regulators with primary oversight responsibility for the regulation of OTC derivatives markets. These discussions include, in addition to the US and Japan, the following jurisdictions: Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, and Switzerland.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

Following a meeting of principals in December 2012, the group of foreign regulators prepared a statement setting forth key understandings with respect to clearing determinations; sharing of information and supervisory and enforcement cooperation; understanding on timing of application of OTC requirements; and different possible approaches to regulating persons, transactions and infrastructures with respect to cross-border activity when more than one set of rules apply.

In addition, the December 2012 statement included a list of further actions that will be taken in 2013. These include options to address identified conflicts, inconsistencies and duplicative rules; a review of the basis for determinations of comparability of regulatory regimes; informing each other of the planned timing of the finalization and implementation of rules and possible transition periods; and development of a consultation procedure in making any final determinations regarding which derivatives products will be subject to a mandatory clearing requirement.

The CFTC has registered foreign swap dealers from Australia, Canada, the European Union, Hong Kong, and Switzerland. To facilitate the registration process for the non-US swap dealers, in December 2012 the Commission granted time-limited relief until July 2013 for non-U.S. swap dealers from certain Dodd-Frank swap requirements. Under this relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

The CFTC will continue to engage with domestic and foreign regulators.

Senator Charles E. Grassley

- 1.) Chairman Gensler, I want to thank you for reaching out to me regarding the manipulation of LIBOR. On February 21st in an interview with Bloomberg News, you referenced your concerns regarding the integrity of LIBOR saying that some might see the rate as "too big to replace" despite concerns about its integrity.
 - a.) I am also concerned that some have taken this view of LIBOR. In addition to pegging LIBOR to real transactions, what suggestions would you make to create a sustainable benchmark rate that would not be so vulnerable to manipulation?
 - b.) Are you concerned that we are in danger of reverting back to LIBOR without any meaningful reforms?

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

Response: I believe that continuing to reference benchmark rates such as LIBOR and Euribor is unsustainable in the long run. These benchmarks basically have not adapted to the significant changes in the market. Thus, the challenge we face is how the financial system adapts to this significant shift.

International regulators and market participants have begun to discuss transition. The CFTC and the FSA are co-chairing the IOSCO Task Force on Financial Market Benchmarks.

One of the key questions in the consultation with the public is: How do we address transition when a benchmark is no longer tied to sufficient transactions and may have become unreliable or obsolete?

Without transactions, the situation is similar to trying to buy a house, when the realtor cannot provide comparable transaction prices in the neighborhood – because no houses were sold in the neighborhood in years.

Moving on from LIBOR and Euribor may be challenging. Today, LIBOR is the reference rate for 70 percent of the U.S. futures market, most of the swaps market and nearly half of U.S. adjustable rate mortgages. But a reference rate has to be based on facts, not fiction.

While ongoing international efforts targeting benchmarks have focused on governance principles, these efforts cannot address the central vulnerability of LIBOR, Euribor and similar interest rate benchmarks: the lack of transactions in the underlying market.

Given the known issues with these benchmarks, their scale and effect on market integrity, it is critical that international regulators work with market participants to promptly identify alternative interest rate benchmarks anchored in observable transactions with appropriate governance, as well as determine how to best smoothly transition to such alternatives.

- 2.) In a recent final rule, the CFTC recognized the compliance burden that the oral communications recordkeeping would have on smaller futures businesses, specifically excluding the requirement for Introducing Brokers that don't exceed a certain revenue threshold. Similarly, commercial grain elevators that largely deal in purchasing cash grain, occasionally take an order from a customer to hedge in the futures markets. Because they are technically a branch operation affiliated with a farmer cooperative futures commission merchant, and not an introducing broker, they will have to record all oral phone conversations. Given the low volume of futures transactions handled by these facilities,

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

complying with such oral recording requirements under Regulation 1.35 could be difficult both economically and from a technical standpoint.

- a.) Given this situation, would CFTC consider treating those branch operations similar to small introducing brokers and exclude them from the oral communications recordkeeping requirements?

Response: Under the Commission's final rule, the requirement to record oral communications does not apply to an introducing broker that has generated over the preceding three years \$5 million or less in aggregate gross revenues from its activities as an introducing broker. In establishing this exception, the Commission noted in the preamble, "notwithstanding the important policy [to promote market integrity and protect customers] and practical reasons for the final rules, the Commission shares many of the commenters' concerns regarding costs and the availability of relevant technology" for recording oral communications. Regarding introducing brokers in particular, the Commission noted that, "while a Small IB takes customer orders, they generally do not execute those orders, meaning that they lack a direct market interface that could affect market integrity. Further, as defined herein, a Small IB is unlikely to generate the volume of market activity that the Commission would expect could affect the integrity of the markets."

- 3.) A lot is being discussed about customer protections in terms of regulations being implemented by the CFTC and some of the Self-Regulatory entities. In addition, customer protections will certainly come up during reauthorization of the Commodity Exchange Act. As we all know, the issue of customer protections is so prevalent because of the recent failures of Peregrine Financial and MF Global. Both of those firms are still going through the bankruptcy process.

- a.) It will be good for the Agriculture Committee to carefully consider proper customer protections during reauthorization of the Commodity Exchange Act; as the ranking member on the Judiciary Committee I am also interested in whether you think there are areas of the bankruptcy law that need to be analyzed as it pertains to protecting customers of futures brokerage firms which go into bankruptcy?

Response: The commodity broker liquidation provisions in Chapter 7 of the Bankruptcy Code are a key component of customer protection. The Commission has commodity broker bankruptcy rules in place today to assist bankruptcy courts in resolving commodity-related cases.

In the course of roundtables hosted by Commission staff, participants have generally discussed bankruptcy code modifications.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

- 4.) I support some of the recent work the CFTC has done in regards to increasing customer protections. That being said, I have heard from farmers and their brokers that they have serious concerns with the CFTC's proposed rule that would require futures brokerages to keep so-called residual interest in their accounts at all times to cover customers' margin requirements. Farmers are concerned about how this will effect the amount of money they would be required to keep in their margin accounts to cover possible moves in the market, whereas currently they provide more funds to cover movements in the market at the end of a given day. In addition there is concern with the practicality of farmers being able to get funds to their brokers potentially on a moment's notice in the middle of the day while they are busy running their farming operations.
- a.) I would like for you to put this proposed rule in the context of the recent collapse of futures brokers. In terms of the two biggest failures in the futures industry in recent years, MF Global and Peregrine Financial, could you explain if, and how, this so-called "residual interest" rule would have helped prevent the failures at MF Global and Peregrine Financial? How would this rule have helped protect customer money in those cases? If this proposed rule would not have had much affect in protecting customer money in MF Global or Peregrine Financial, could you please explain how the CFTC decided this proposed rule was necessary?

Response: The Dodd-Frank Act included provisions directing the CFTC to enhance the protection of swaps customer funds. While it was not a requirement of the Dodd-Frank Act, in 2009 the CFTC also reviewed and updated customer protection rules for futures market customers.

Market events have further highlighted that the Commission must do everything within our authorities and resources to strengthen oversight programs and the protection of customers and their funds.

In the fall of 2012, the Commission sought public comment on a proposal that would strengthen the controls around customer funds at FCMs. It would set new regulatory accounting requirements and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to the FCMs' bank and custodial accounts for customer funds.

The proposal includes a provision on residual interest to ensure that the assets of one customer are not used to cover the positions of another customer. We are considering the comments that have been filed on this and plan to finalize the proposal consistent with the Commodity Exchange Act and the overall goal of protecting customers.

Senator John Thune

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

- 1.) On the subject of the proposed customer-segregation rule, it is intended to prevent another collapse like MF Global or Peregrine Financial Group in which customer segregated funds are at risk. My concern is that the capital requirements are so stringent that smaller brokerages that cater to end-users in states like mine will not be able to survive, or at the very least will drive up costs for end-users like farmers, the very people this rule is intending to protect.
- a.) I understand that the comment period on this rule is now closed. Assuming you heard from end-users and brokerages concerned about the impact of this proposed rule, what steps are you taking to ensure those concerns are addressed before issuing a final rulemaking?

Response: The Commission's proposed rule to enhance protections afforded customers and customer funds was published in the Federal Register on November 14, 2012, with a 60 day comment period. The Commission approved a 30-day extension to that comment period. During the extended period, CFTC staff hosted a public roundtable during which public participants shared their views and expertise.

The Commission received a number of comments on the proposed rule, including some related to FCM capital provisions, and will consider and respond to each of the comments in issuing a final regulation.

- 2.) We've heard U.S. regulators talk about "international harmonization" and the belief that the rest of the world will follow, which played a role in the CFTC's delay in compliance with some of its cross-border derivatives rules last year. It is difficult to see that there will be such harmonization. Will you hit the pause button again as you did in October and in December? Isn't the better way to regulate to be clear that these requirements will be put on hold until an agreement is reached?

Response: Foreign jurisdictions have provided comments on the CFTC's proposed approach to the regulation of cross-border transactions and Commissioners and staff have met on numerous occasions with foreign regulators to discuss mutual concerns

The CFTC and the SEC have convened a series of meetings with market regulators with primary oversight responsibility for the regulation of OTC derivatives markets. These discussions include, in addition to the US and Japan, the following jurisdictions:

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, and Switzerland.

Following a meeting of principals in December 2012, the group of foreign regulators prepared a statement setting forth key understandings with respect to clearing determinations; sharing of information and supervisory and enforcement cooperation; understanding on timing of application of OTC requirements; and different possible approaches to regulating persons, transactions and infrastructures with respect to cross-border activity when more than one set of rules apply.

In addition, the December 2012 statement included a list of further actions that will be taken in 2013. These include options to address identified conflicts, inconsistencies and duplicative rules; a review of the basis for determinations of comparability of regulatory regimes; informing each other of the planned timing of the finalization and implementation of rules and possible transition periods; and development of a consultation procedure in making any final determinations regarding which derivatives products will be subject to a mandatory clearing requirement.

The CFTC has registered foreign swap dealers from Australia, Canada, the European Union, Hong Kong, and Switzerland. To facilitate the registration process for the non-US swap dealers, in December 2012 the Commission granted time-limited relief until July 2013 for non-U.S. swap dealers from certain Dodd-Frank swap requirements. Under this time-limited relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

The CFTC will continue to engage with domestic and foreign regulators.

- 3.) There has been a lot of focus in the industry press about so-called "futurization" – that is the increased use of futures instead of swaps because of all the uncertainty surrounding the swaps rules, particularly in the energy space. It is interesting to see futurization being made out to be a bad thing, because the futures are more highly regulated. But given the uncertainty with regard to swaps, and the piecemeal approach being taken in the implementation of the swaps rule, doesn't it make sense that folks would turn toward futures, even though they are more regulated, out of a desire for regulatory certainty?

Response: The swaps market emerged in the 1980s, but until now, it lacked the benefit of futures and securities market rules that have served to promote transparency, lower risk and protect investors. What followed was the 2008 financial crisis. Eight million American

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

jobs were lost. In contrast, the futures market, supported by earlier reforms, weathered the financial crisis. Now that the entire derivatives marketplace -- both futures and swaps -- has comprehensive oversight, it's the natural order of things for some realignment to take place.

The notional open interest of the futures market ranges around \$30 trillion. There are various estimates for the notional size of the U.S. swaps market, but it ranges around \$250 trillion. Though the futures market trades more actively, just one-ninth or so of the combined open interest in the derivatives marketplace is futures. Approximately eight-ninths of the combined derivatives marketplace is swaps, which until recently were unregulated.

Last fall, IntercontinentalExchange converted power and natural gas-related swaps into futures contracts. In addition, the CME Group's ClearPort products, which were cleared as futures, including those that were executed bilaterally as swaps, are now being offered for trading on Globex or on the trading floor. CME also adopted new block trading rules for its ClearPort energy contracts, and it began trading a futures contract where the underlying product is an interest rate swaps contract.

It's important to note that whether one calls a product a standardized swap or a future, both markets will now benefit from central clearing. In addition, transparency has been a longstanding hallmark of the futures market -- both pre-trade and post-trade. Now, for the first time, the swaps market is benefitting from post-trade transparency, and the Commission has adopted pre-trade transparency rules as well.

- 4.) The Commission has said that guarantees of swaps are themselves swaps. In addition to creating a great deal of uncertainty in areas such as cross-border jurisdiction and swap dealer and major swap participant calculations, this is directly contrary to what the SEC concluded in the same rulemaking, where they said guarantees of security based swaps are not themselves security based swaps. How is this consistent with the statutory requirement that the two agencies coordinate their rules, and can you tell me where in the swap definition guarantees appear?

Response: The final rule further defining the term "swap" that was adopted jointly by the CFTC and the SEC, provides that when a swap has the benefit of a guarantee where the counterparty would have recourse to the guarantor in connection with the position, the guarantee is price forming and an integral part of that swap. That is, when a swap has the benefit of a guarantee with recourse, the guarantee and related guaranteed swap must be analyzed together. The Commission also explained the interplay with the definitions of the terms "swap dealer" and "major swap participant" in the joint final rule by noting that if a U.S. entity that operates with a parent or holding company guarantee is already subject to

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

capital regulation by the CFTC, the Commission will not deem the guarantor to be a swap dealer or major swap participant.

The Dodd-Frank Act provides that, while the CFTC and SEC are to treat functionally or economically similar products similarly, they need not be treated in an identical manner. The SEC has a statutory basis for not adopting an interpretation that a guarantee of a security-based swap is part of the security-based swap. In the release of the final rule, the SEC noted that security-based swaps are included in the definition of 'security' contained in the securities statutes. Under the securities acts, a guarantee of a security is also a security and subject to Federal securities law regulation.

5.) Why did the CFTC say that all options are swaps, ignoring the fact that Congress preserved the CFTC's existing authority over options? Why doesn't the Commission clarify that an option to buy a nonfinancial commodity – purchased by a commercial business that intends to use the product in its business, and not for financial speculation of any kind – is completely outside regulation as a swap?

6.) Well before the April 10 reporting deadline, will the CFTC give guidance to end users on which volumetric options must be reported as swaps? And will this guidance clarify that options in a commercial forward that are used in the ordinary course of business, and not for financial speculation, are covered by the forward exemption?

Response to questions 5 and 6: The final rule further defining the term "swap" that was adopted jointly by the CFTC and the SEC, notes that the statutory definition of the term "swap" enacted in the Dodd-Frank Act explicitly provides that commodity options are swaps. The statutory swap definition includes agreements, contracts, or transactions to include any put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind. The statutory definition encompasses options on both financial and nonfinancial commodities.

The Dodd-Frank Act did not amend Section 4c(b) of the CEA, which bans options other than pursuant to such terms and conditions as the Commission shall prescribe. The Commission exercised this authority to issue its trade option exemption. Under that rule, trade option counterparties and other trade option-related service providers are exempt from much of the swap regulatory scheme, subject to certain conditions intended to limit the trade option exemption to commercial businesses.

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

After issuing the rule further defining the term “swap” and the trade option exemption, the CFTC received comment letters from, and staff met frequently with, end users and their representatives and advisors to hear their concerns. On April 5, 2013, CFTC staff issued a no-action letter, which provided further relief to entities that are neither swap dealers nor major swap participants with respect to the reporting and recordkeeping requirements relating to trade options. Transactions with volumetric optionality that are not forward contracts under the interpretation in the release are eligible for the trade option exemption and the trade option reporting and recordkeeping no-action relief.

- 7.) There has been considerable debate around the intent of Sec. 722 of Dodd-Frank and the aggressive approach being taken by the CFTC to apply derivatives rules to U.S. banks doing business overseas with foreign clients. This approach has been criticized by market participants, and, maybe most noteworthy, foreign regulators as missing the mark and potentially exacerbating rather than ameliorating the problem. Given that foreign regulators have raised concerns about the potential application of Title VII in their jurisdictions, I am concerned about similar reciprocal measures being enacted by the E.U. or other foreign regulators in response. Can you please provide the Committee with details about how the agency intends to reach an agreement with the key European countries to resolve this dispute?
- 8.) Given developments late last year – unnecessary disruptions around Oct. 12 deadlines, last minute “no-action” letters, reports that foreign banks wouldn’t do business with US firms, an interim final rule, etc. – why should Congress have any level of confidence that you’re moving in the right direction and that markets won’t be negatively impacted by actions of the CFTC? Also, how do you intend on getting the rest of the world to follow the U.S. when the SEC and CFTC rules currently don’t align on timing, process or content in many areas? What happens later this year if there is still not international harmonization or even domestic harmonization?

Response to (7) and (8): Foreign jurisdictions have provided comments on the CFTC’s proposed approach to the regulation of cross-border transactions and Commissioners and staff have met on numerous occasions with foreign regulators to discuss mutual concerns

The CFTC and the SEC have convened a series of meetings with market regulators with primary oversight responsibility for the regulation of OTC derivatives markets.

Senate Committee on Agriculture, Nutrition & Forestry
 Oversight of the Commodity Futures Trading Commission
 February 27, 2013
 Questions for the Record
 Chairman Gary Gensler

These discussions include, in addition to the US and Japan, the following jurisdictions: Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, and Switzerland.

Following a meeting of principals in December 2012, the group of foreign regulators prepared a statement setting forth key understandings with respect to clearing determinations, sharing of information and supervisory and enforcement cooperation, understanding on timing of application of OTC requirements and different possible approaches to regulating persons, transactions and infrastructures with respect to cross-border activity when more than one set of rules apply.

In addition, the December 2012 included a list of further actions that will be taken in 2013. These include options to address identified conflicts, inconsistencies and duplicative rules; a review of the basis for determinations of comparability of regulatory regimes; informing each other of the planned timing of the finalization and implementation of rules and possible transition periods; and development of a consultation procedure in making any final determinations regarding which derivatives products will be subject to a mandatory clearing requirement.

The CFTC has registered foreign swap dealers from Australia, Canada, the European Union, Hong Kong, and Switzerland. To facilitate the registration process for the non-US swap dealers, in December 2012 the Commission granted time-limited relief until July 2013 for non-U.S. swap dealers from certain Dodd-Frank swap requirements. Under this time-limited relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

The CFTC will continue to engage with domestic and foreign regulators.

- 9.) Why are such significant reforms – like your cross-border guidance – being made through guidance and no-action letters versus a formal rulemaking process? Is it to avert Administration Procedures Act (APA) requirements? Wouldn't all parties benefit from formally proposed rules?

Response: Section 722(d) of the Dodd-Frank Act states that swaps reforms shall not apply to activities outside the United States unless those activities have “a direct and significant connection with activities in, or effect on, commerce of the United States.” The Commission has received numerous requests from market participants with regard to the interpretation of this provision.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

The Commission, consulting closely with the SEC, the Federal Reserve and the Treasury Department, issued proposed guidance interpreting this section of the law. To facilitate the registration process for the non-US swap dealers, in December 2012 the Commission granted time-limited relief until July 2013 for non-U.S. swap dealers from certain Dodd-Frank swap requirements. Under this time-limited relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers. Such phased compliance will enable market participants to comply with the Dodd-Frank Act in an orderly fashion and allow time for the CFTC to receive and evaluate public comment on the cross-border interpretive guidance. The Commission's Global Markets Advisory Committee also addressed these matters in a public meeting. The Commission is carefully reviewing all comments submitted in connection with the proposed guidance.

Market participants have requested that Commission staff issue no-action relief from certain swap provisions of the CEA or swap rules that have been adopted by the Commission. After careful consideration of the issues raised, the staff, in appropriate circumstances, has granted such relief and agreed not to recommend an enforcement action to the Commission, provided that any appropriate conditions are satisfied.

10.) A purpose of including the formation of Swap Execution Facilities in Dodd-Frank was to encourage price transparency, but there is nothing in the statute that directs the agencies to require a certain number of trade submissions as a prerequisite to qualify for trading as a SEF. In fact, the SEC's proposal does not have this requirement, so this clearly isn't a statutory necessity. But there is significant downside to mandating this requirement. Requiring a certain number would reduce liquidity, increase trading costs and actually could impair transparency. Shouldn't we allow the SEF landscape to develop without imposing such inflexible requirements? If, as these platforms develop, the agency learns through experience that a minimum requirement is necessary, it can always revise the standards.

Response: On May 16, 2013, the Commission approved the final rulemaking on swap execution facilities (SEFs). This rule is key to fulfilling transparency reforms that Congress mandated in the Dodd-Frank Act.

The Dodd-Frank Act included a trade execution requirement for swaps. Swaps subject to mandatory clearing and made available to trade were to move to transparent trading platforms. Market participants will benefit from the price competition that comes

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

from trading platforms where multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants. Congress also said that the market participants must have impartial access to these platforms.

Farmers, ranchers, producers and commercial companies that want to hedge a risk by locking in a future price or rate will get the benefit of the competition and transparency that trading platforms, both SEFs and designated contract markets (DCMs), will provide.

These transparent platforms will give everyone looking to compete in the marketplace the ability to see the prices of available bids and offers prior to making a decision on a transaction. By the end of this year, a significant portion of interest rate and credit derivative index swaps will be in full view to the marketplace before transactions occur. This is a significant shift toward market transparency from the status quo.

Such common-sense transparency has existed in the securities and futures markets since the historic reforms of the 1930s. Transparency lowers costs for investors, businesses and consumers, as it shifts information from dealers to the broader public. It promotes competition and increases liquidity.

As Congress made clear in the law, trading on SEFs and DCMs would be required only when financial institutions transact with financial institutions. End-users would benefit from access to the information on these platforms, but would not be required to use them.

Further, companies would be able to continue relying on customized transactions – those not required to be cleared – to meet their particular needs, as well as to enter into large block trades.

Consistent with Congress' directive that multiple parties have the ability to trade with multiple parties on these transparent platforms, these reforms require that market participants trade through an order book, and provide the flexibility as well to seek requests for quotes.

To be a registered SEF, the trading platform will be required to provide an order book to all its market participants. This is significant, as for the first time, the broad public will be able to gain access and compete in this market with the assurance that their bids or offers will be communicated to the rest of the market. This provision alone will significantly enhance transparency and competition in the market.

SEFs also will have the flexibility to offer trading through requests for quotes. The rule provides that such requests will have to go out to a minimum of three unaffiliated market participants before a swap that is cleared, made available to trade and less than a

Senate Committee on Agriculture, Nutrition & Forestry
Oversight of the Commodity Futures Trading Commission
February 27, 2013
Questions for the Record
Chairman Gary Gensler

block could be executed. There will be an initial phase-in period with a minimum of two participants to smooth the transition.

As long as the minimum functionality is met, as detailed in the rule, and the SEF complies with these rules and the core principles, the SEF can conduct business through any means of interstate commerce, such as the Internet, telephone or even the mail. In this way, the rule is technology neutral.

Under these transparency reforms coupled with the Commission's rule on making swaps available for trading, the trade execution requirement will be phased in for market participants, giving them time to comply.

These reforms benefited from extensive public comments. Moving forward, the CFTC will work with SEF applicants on implementation.



FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2014

TUESDAY, JUNE 25, 2013

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:11 p.m., in room SD-138, Dirksen Senate Office Building, Hon. Tom Udall (chairman) presiding.
Present: Senators Udall, Coons, Johanns, and Moran.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. GARY GENSLER, CHAIRMAN

OPENING STATEMENT OF SENATOR TOM UDALL

Senator UDALL. We are going to bring the subcommittee to order. I am pleased to convene this hearing of the Financial Services and General Government subcommittee to consider the fiscal year 2014 funding request for two key Federal regulatory agencies, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).

I welcome my distinguished ranking member, Senator Mike Johanns, and our colleagues here today with us, and others who also may arrive in a little bit.

Joining us today are the Honorable Gary Gensler, the Chairman of the Commodity Futures Trading Commission, and the Honorable Mary Jo White, the Chairman of the Securities and Exchange Commission. They will discuss the critical work of their agencies, share how they have used the resources provided over the past couple of years, and explain the details of their budgetary needs for fiscal year 2014.

The subcommittee has received a statement for the record from Colleen Kelley, President of the National Treasury Employees Union, regarding the funding for the FCC. If there's no objection, I'd ask it be included in the record of these proceedings. Great. It will be included in the record.

[The statement follows:]

PREPARED STATEMENT OF THE NATIONAL TREASURY EMPLOYEES UNION

Chairman Udall, Ranking Member Johanns and members of the Subcommittee on Financial Services and General Government Appropriations, thank you for the opportunity to present this statement on behalf of the National Treasury Employees Union (NTEU). Our union is proud to represent the bargaining unit staff at the Securities and Exchange Commission (SEC).

What is the status and forecast for republishing the position on that rule?

Mr. GENSLER. Mr. Chair, I do think it's important as we have, as we sought the appellate court's guidance on this. Because I would speak just as one Commissioner. I think Congress was quite clear that we were to do these rules. And I've had very lively discussions with Senator Moran, I see, on that.

And of course, one district court said, "Well, maybe not." So we simultaneously are looking, as you said, to following the guidance from that district court to move forward, and also reissue that rule. And if I can borrow from Chair White's answer to the crowdfunding question, it's a very high priority. It's a document that is coming together. And I hope would be in front of the Commissioners this summer. That will give a little bit of sense of timing.

Senator UDALL. Great. Thank you very much.

Senator Moran, do you want to go for another round, or shall we close up here?

Senator MORAN. Mr. Chairman, I'm satisfied for the moment.

Senator UDALL. Okay. Thank you very much.

And let me thank all who participated in preparing for this hearing. I appreciate the discussion with the top officials of these two pivotal agencies about their funding needs.

Today's discussion, I think, has been very helpful, with valuable insights into the agency's operations and challenges. This information will be instructive as we further consider the budget proposals and as we develop our fiscal year 2014 bill over the coming weeks.

ADDITIONAL COMMITTEE QUESTIONS

The hearing record will remain open until next Tuesday, July 2, at 12 noon, for subcommittee members to submit statements and/or questions to be submitted to witnesses for the record.

[The following questions were not asked at the hearing, but were submitted to the agencies for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO GARY GENSLER

QUESTIONS SUBMITTED BY SENATOR TOM UDALL

POSITION LIMITS AND REDUCING EXCESSIVE SPECULATION

Question. The enactment of the Dodd-Frank Act included several provisions designed to insulate commodity prices from the impact of excessive speculation and manipulation. For example, under section 737, the Commodity Futures Trading Commission (CFTC) was directed to establish position limits—a cap on the size of the bets—for both swaps and futures.

In October 2011, the CFTC approved and published final rules establishing position limits for 28 different commodities. The position limit rule, which would have taken effect in October 2012—60 days following the August 13 issuance of a final rule defining "swaps"—was issued in response to Congress' concern that no single trader be permitted to obtain too large a share of the market, and that derivatives markets remain fair and competitive.

On September 28, 2012, a Federal court struck down the CFTC's efforts to impose speculative position limits because the CFTC did not explicitly demonstrate that its rules were "necessary and appropriate." The court vacated and remanded the rule to the CFTC. The CFTC appealed the ruling, and there may be action underway to reissue the rule.

What is the status and forecast for republishing the position limit rule?

Answer. Staff is preparing a revised notice of proposed rulemaking, taking into account matters addressed in the court decision. The staff recommendation is expected to be available for consideration by the Commission in the near future.

Question. When it comes to speculation, is it relatively easy to differentiate between normal speculation, excessive speculation, and manipulation?

Answer. Farmers, ranchers, producers, processors and packers all rely on futures and swaps markets to lock in the price of a commodity and manage risk. The futures and swaps markets help them to focus on what they do best—producing food and fiber and other products for the Nation. The Commodity Exchange Act includes the finding that excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity is an undue and unnecessary burden on interstate commerce. In setting position limits generally, the agency sought to ensure that the markets were made up of a broad group of participants with a diversity of views. At the core of our obligations is promoting market integrity, which the agency has historically interpreted to include ensuring that markets do not become too concentrated. The act directs that the Commission set position limits at levels that would serve to the maximum extent possible to diminish, or prevent excessive speculation; deter and prevent market manipulation, squeezes, and corners; ensure sufficient market liquidity for bona fide hedgers; and ensure that the price discovery function of the underlying market is not disrupted.

The Commission's rule implementing the Dodd-Frank Act's anti-manipulation provision sets in place a broad new ability to effectively combat fraud and manipulation. The Commission can explicitly act against fraud-based manipulation. Congress also gave the Commission authority to prohibit trading practices that are disruptive of fair and equitable trading. With adequate resources, these and other authorities are available to be used by the Commission to promote and ensure fair and orderly trading, free from fraud, manipulation and other abuses.

Question. Has the CFTC conducted studies on the impact of position limits on excessive speculation? If so, what have those studies concluded?

Answer. As part of rulemaking regarding Position Limits for Futures and Swaps, the Commission reviewed over 50 studies by institutional, academic, and industry professionals that were cited by commenters. Some were supportive of position limits, some were opposed, and many expressed no view on position limits. Thirty-eight of these studies were focused on the impact of speculative activity in futures markets and did not address position limits. The other 14 studies mentioned position limits, but did so only as part of a broader discussion of the role of speculation. None addressed the question of how the Commission should specifically implement the required limits to advance the objectives set forth in the Commodity Exchange Act.

Question. What are the key pieces of data that the CFTC currently analyzes to determine whether forces other than supply and demand are impacting the futures price of a particular commodity?

Answer. Commission personnel examine trading activity and positions.

Question. What are the "tests" for discerning the legitimate from the questionable?

Answer. The CFTC analyzes the data it gathers to detect trade practice violations, disruptive trading practices, and concentrations of positions indicative of market power. The CFTC depends on experienced surveillance staff using both regular tests and ad hoc reviews of the data.

ENFORCEMENT ACTIVITIES

Question. Detecting and deterring against illegitimate market forces requires the CFTC's steady vigilance and swift response. Market users and others must be protected from possible wrongdoing that may affect or tend to affect the integrity of the markets.

One of the CFTC's five strategic goals is to ensure that firms and individuals who come to the marketplace to fulfill their business and trading needs are in compliance with applicable laws and regulations. CFTC's most recent Performance Report describing the CFTC's accomplishments during fiscal year 2012 highlight some commendable results:

- 102 enforcement actions, the highest in the agency's history.
- Opening of more than 350 new investigations—among the highest annual counts.
- Resolution of a landmark case against Barclays PLC and two affiliates for manipulations and false reporting concerning LIBOR and other global benchmark interest rates—resulting in a \$200 million fine, the largest penalty ever imposed by the CFTC.

Let me preface by saying that these accomplishments are impressive.

Do the significant increases in the caseload suggest that there is more illicit activity occurring or is it because the CFTC is becoming more adept at rooting it out?

How rapidly is the CFTC able to collect restitution, disgorgement of ill-gotten gains, and civil monetary penalties imposed against violations of the Federal commodities laws? What is the recovery rate? Are there any statutory or administrative impediments that prevent the CFTC from doing more to combat fraud? What tools do you lack?

Answer. A combination of factors has contributed to increased enforcement activity by the Commission in recent years, but our ability to pursue actions is highly dependent on the availability of resources. When resources permitted, the Division of Enforcement hired additional staff attorneys and investigators to keep up with the demands of the docket. As a result, the number of investigations opened increased. Also contributing is the fact that the Commission has been granted new oversight authority. The Dodd-Frank mandate closed a significant gap in the agency's enforcement authorities by extending the enforcement reach to swaps and prohibiting the reckless use of manipulative or deceptive schemes. In addition, the CFTC will be overseeing a host of new market participants.

However, the Division currently has a staff of 156—about the same size as it was in 2002.

The following table demonstrates the Commission's results regarding penalties imposed and those collected through the first few months of fiscal year 2013.

CIVIL MONETARY PENALTIES
(Fiscal Year 1994 - Fiscal Year 2013)

| Fiscal Year | Penalties Imposed | Penalties Collected |
|-------------|-------------------|---------------------|
| 1994 | \$4,117,407 | \$3,134,766 |
| 1995 | 11,201,100 | 9,430,239 |
| 1996 | 1,335,000 | 1,526,000 |
| 1997 | 4,537,000 | 1,757,636 |
| 1998 | 132,623,756 | 125,803,781 |
| 1999 | 85,863,311 | 22,165,368 |
| 2000 | 179,811,562 | 3,799,367 |
| 2001 | 16,876,335 | 3,170,252 |
| 2002 | 9,942,382 | 5,922,387 |
| 2003 | 110,764,937 | 87,699,077 |
| 2004 | 302,049,939 | 122,468,925 |
| 2005 | 76,672,758 | 34,163,077 |
| 2006 | 197,971,794 | 17,364,509 |
| 2007 | 345,614,139 | 12,137,848 |
| 2008 | 234,835,121 | 140,745,252 |
| 2009 | 99,489,609 | 17,367,486 |
| 2010 | 136,040,764 | 75,111,675 |
| 2011 | 316,682,679 | 11,343,236 |
| 2012 | 475,360,925 | 257,567,359 |
| 2013 | 1,326,645,157 | 1,031,806,815 |

¹ Includes \$30,065 for civil monetary penalties imposed in prior years.

² Includes \$617,409 for civil monetary penalties imposed in prior years.

³ Collections as of fiscal year 2012.

The discrepancy between the amount of civil penalties imposed and the amount collected is accounted for by the following factors: (1) when courts order the defendants to both pay restitution to victims and a civil monetary penalty to the Commission, established Commission policy directs available funds to satisfy restitution obligations first; (2) in fraud actions, it is not uncommon that the proceeds of the fraud have been dissipated and/or that the penalty far exceeds the defendants' represented financial ability to pay; (3) delinquencies assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (4) penalties imposed on 1 year may not become due and payable until the next year; (5) a penalty may be stayed by appeal; (6) some penalties call for installment payments that may span more than 1 year; (7) penalties have been referred to the Attorney General for collection; and (8) collection still in process internally.

The President's budget for fiscal year 2014 includes an estimate of \$57.7 million and 213 FTEs for enforcement.

A full increase for enforcement means more investigations and cases that the agency can pursue to protect the public. A less than full increase means that the CFTC will be faced with difficult choices. We could maintain the current volume and types of cases, but we would have to shift resources from futures cases to swaps cases or not cover all of the swaps market. Flat funding means not only that the Commission's enforcement volume likely would shrink, but parts of the markets would be left with little enforcement oversight.

ANNUAL EXAMS

Question. The CFTC regulates the activities of nearly 63,000 registrants who handle customer funds, solicit or accept orders, or give trained advice. Among these registrants are commodity pool operators, futures commission merchants, floor brokers, floor traders, and salespersons. CFTC delegates oversight authority to the National Futures Association, a self-regulatory organization (SRO).

The CFTC is constrained through limited resources from conducting reviews of CFTC registrants, more frequently than once every 3 years. Because of the triennial cycle, the ability to check compliance is diluted. The CFTC also would prefer to perform regular and direct reviews of all exchanges and intermediaries and to assess their compliance with the Commodity Exchange Act (CEA) rather than relying on Designated Self-Regulatory Organizations for these reviews.

What would be the advantages of performing more frequent reviews of registered entities (e.g., annual rather than triennial)? To what extent do you believe there is a risk that an ineffective self-regulatory program may go undetected or a systemic risk may not be identified if frequency of reviews remains triennial? Would more frequent reviews require adding staff with expertise in trading and build CFTC's knowledge base of how exchanges' various electronic trading platforms operate and how violations may occur on and across electronically traded markets?

Answer. Annual Exams: Examinations are the CFTC's tool to check for compliance with laws that protect the public and to ensure the protection of customer funds. The President's budget request for fiscal year 2014 would provide \$44.3 million and 185 FTEs for examinations, an increase of \$25.6 million and 104 FTEs over current levels. The CFTC would more than double our current allocation for this mission because the number of entities we examine is expected to more than double.

This is an area where the agency has fallen short of our goals in performance reviews. For intermediaries such as futures commission merchants (FCMs) and swap dealers, the CFTC relies on what are known as self-regulatory organizations (SROs) to be the primary examiners. Given our lack of resources, we're only able to double check the SROs' work on a limited number of FCMs each year, and the agency can spend little time onsite at the firms. Our budget also doesn't allow us to review commodity pool operators or commodity trading advisors.

On top of the current lack of staff for examinations, our responsibilities in 2014 will expand to include reviews of many new market participants. For instance, there are currently 106 FCMs, 82 swap dealers and two major swap participants have provisionally registered, and more are expected to do so. More frequent and in-depth examinations are necessary to assure the public that firms have adequate capital, as well as systems and procedures in place to protect customer money. Reviews are critical to ensuring the financial soundness of clearinghouses, and ensuring transparency and competition in the trading markets.

The President's budget for fiscal year 2014 would provide the funding estimated to be necessary for more thorough reviews. Fully funding the increase for examinations means the Commission can move toward annual reviews of all significant clearinghouses and trading platforms and adequate reviews of other market participants. A partial increase for examinations means cutting back our monitoring plans for new market participants and more in-depth risk reviews. Flat funding means we will continue lacking the ability to assure the public that the CFTC's registrants are financially sound and in compliance with regulatory protections.

QUESTIONS SUBMITTED TO MARY JO WHITE

QUESTIONS SUBMITTED BY SENATOR TOM UDALL

MARKET MUTUAL FUND REGULATIONS

Question. As you know, I have written to the Securities and Exchange Commission (SEC) with some concerns about the future of market mutual funds (MMFs). Given the role that market mutual funds play in short-term financing for State and local governments, I have been contacted by constituents who share my concerns that a floating Net Asset Value (NAV) will alter the nature of MMFs and tighten capital availability and raise costs.

Has the SEC reached out to local governments to learn more about their concerns?

Answer. In crafting the proposal, the Commission and its staff engaged in a deliberative process that included reaching out to many interested parties, including representatives of State and local governments. For example, I understand that in March of this year, Commission staff met with representatives from the National